

COMMODITY INVESTMENT FRAUD

REPORT
OF THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

MADE BY THE
PERMANENT SUBCOMMITTEE ON
INVESTIGATIONS
together with
ADDITIONAL VIEWS



JULY 13 (legislative day, JULY 12), 1982.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

89-010 O

WASHINGTON: 1982

5403-13

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INTRODUCTION

The trading of commodity futures and other commodity related contracts is a vast and growing industry in the United States. In 1981, the volume of trading on legitimate commodity exchanges approached 1 trillion contracts.¹ This mammoth industry is currently under the regulatory jurisdiction of the Commodity Futures Trading Commission (CFTC), pursuant to the Commodity Exchange Act of 1975 (7 U.S.C. § 1 et seq.). Questions about the ability of this relatively small agency to effectively regulate all aspects of the sprawling futures industry attracted the attention of the Permanent Subcommittee on Investigations.

The Subcommittee is authorized to conduct investigations into waste, fraud and abuse in the agencies of the federal government and into all aspects of organized crime in the United States. A preliminary inquiry by the Subcommittee found that there were serious problems with off-exchange commodity investment fraud and raised many questions as to the ability of the CFTC to handle these problems. The Subcommittee leadership decided that an extensive investigation should be undertaken to determine the causes and extent of such fraud and to consider possible remedies.

Over an eight-month period, Subcommittee investigators reviewed thousands of law enforcement and CFTC files, and interviewed more than 200 commodity fraud victims, commodity sales operators, court-appointed receivers and law enforcement officials at the federal, state and local levels. Exhaustive studies of CFTC cases and complaints were conducted. Investigators visited operating commodity sales companies and inquired into the mechanics of day-to-day business.

As a result of these efforts, the Subcommittee was able to determine that an average of more than \$200 million a year is lost to "off-exchange" commodity fraud, accounting for estimated losses of over one billion customer dollars in the past five years. The Subcommittee discovered that the majority of commodity fraud schemes are contrived by an identifiable cadre of recidivists who systematically generate fraudulent operations throughout the country. By operating primarily outside of the large commodity exchanges, these recidivists are able to successfully elude the CFTC and continue to bilk thousands of investors nationwide. Little recourse for defrauded victims is available and most never see any of their investment again.

The Subcommittee also discovered serious problems with the current regulatory scheme, particularly with regard to the effectiveness and

¹ According to the Contracts Section of the CFTC's Division of Trading and Markets, the Volume of contracts traded on the 11 approved contracts markets was 98,522,371 in calendar year 1981. This figure does not take into account off-exchange transactions, leverage trading and trading not allowed under the Commodity Exchange Act.

the ability of the CFTC to regulate every aspect of commodity trading nationwide. The Subcommittee thus explored alternative avenues of commodity regulation, particularly the possibility of greater authority on the state and local level. The justifications for the present federal preemption of state jurisdiction, the different resources available to the states to combat commodity fraud, and the ability and willingness of state authorities to assume a regulatory role, were all scrutinized by the Subcommittee.

On February 23, 24, and 25, 1982, the Subcommittee held public hearings designed to define the extent of the fraud problem, examine its impact upon the economy, and educate the investing public as to the nature of the more prevalent illegal operations. The Subcommittee also sought to determine whether additional enforcement resources must be committed.

The Subcommittee hopes that the publicity generated by these hearings will alert the investing public and will encourage more vigorous prosecution of commodity scheme operators who have enjoyed relative obscurity, hiding behind the mistaken assumption that such schemes are too complex for effective prosecution. By illuminating the nature and extent of these frauds, the Subcommittee has attempted to apply new pressure on these illegal operations, both from informed investors and highly motivated law enforcement officials.

COMMODITY INVESTMENT FRAUD

JULY 13 (legislative day, JULY 12), 1982.—Ordered to be printed

Mr. ROTH, from the Committee on Governmental Affairs,
submitted the following

REPORT together with ADDITIONAL VIEWS

TRADING IN COMMODITIES AND COMMODITY RELATED INSTRUMENTS

Commodity futures trading has experienced phenomenal growth in recent years. Unfortunately, this explosive growth in the futures trading industry has not been paralleled by a similar evolution in the public's comprehension of the nature of exchange traded contracts. Even less understood are the garden variety of off-exchange traded instruments currently available to investors. This lack of comprehension has tended to hamper effective regulation and create an atmosphere ripe for fraud. Thus, for purposes of understanding the complex nature of the futures industry, it is helpful to first trace the development of commodities trading in the United States.

HISTORY OF TRADING IN THE UNITED STATES

Commodity trading, which enjoys a lengthy European history, was introduced in America in the late 1700's. Initially, trade was limited to eggs, butter, vegetables and grain and was confined to exchanges which acted largely as cash markets for "spot" (i.e. non-future) delivery.² Farmers, who generally brought their goods to market at the same time each year, soon found that supply far exceeded immediate market needs, allowing processors to offer the lowest possible price for goods which temporarily glutted the market. Standards of quality and weight were often nonexistent, while the lack of storage facilities and transportation created additional difficulties. As a result, "forward contracting" gradually developed in the United States.³ Forward contracting involves the sale of a commodity on a spot market with deferred delivery. While easing problems of supply and demand, for-

² See Clark, Genealogy and Genetics of "Contract of Sales of a Commodity for Future Delivery" in the Commodity Exchange Act, 27 Emory Law Journal 1175, 1179 (1978).

³ Supra, footnote 2, at 1180.

ward contracting did little to control the financial risk of loss by producers due to rapidly changing prices resulting from crop failures, losses of ships, inadequate storage and transportation, and recurring economic panics.⁴

Agricultural commodity "futures" trading developed in the U.S. between 1850-1900, first in Chicago (grain) and later in New York (cotton). Unlike forward contracting, futures trading does not involve the sale of commodities for later delivery but consists of the formation of contracts obligating the later sale of a commodity of specified grade and amount at a date and place certain.⁵ The margin or security deposit can be lost, along with the remaining debt obligation, although such contracts are normally liquidated in the market.

The futures market developed in response to the increasing economic need for centralized pricing and large-scale risk bearing in the agricultural market.⁶ Through the buying and selling of futures contracts, traders were able to discover the general consensus of what traders believed the price ought to be in the future, based on existing information. By projecting demand and price into the future, futures trading provides a means of appraising supply-and-demand conditions and dealing with price risks over time and distance.⁷

The emerging system soon adopted the principle of "hedging" to provide protection for the increased capital needed for the large-scale marketing of grains and cotton. Hedging refers to sales or purchases in futures against inventories or commitments in the cash commodity. As a result of hedging, price risks are reduced or offset, enabling merchants with limited capital to handle larger commodity requirements.⁸ Speculators also entered the markets in increasing numbers, assuming risks in return for potential profits.

FEDERAL REGULATION

Speculative excesses, irresponsible trading and lack of effective market regulation eventually stirred farm resentment and led to a movement in the late 1800's to abolish futures trading.⁹ These abolition efforts gave way to federal regulation and resulted in the Cotton Futures Act of 1917,¹⁰ which placed futures and cash forward contracts in the same category and taxed transactions where actual or constructive delivery took place on the major exchanges.

A similar approach was taken several years later in the Futures Trading Act of 1921,¹¹ which attempted to tax futures contracts on grain sales. Ostensibly based on the taxing power under the Constitution, the Act contained a number of defects and was subsequently declared unconstitutional by the U.S. Supreme Court. The Act was reintroduced and enacted in 1922 as the Grain Futures Act,¹² based on

⁴ S. Rep. No. 850, 95th Cong., 2nd Sess. 5 (1978).

⁵ *Supra*, footnote 2, at 1175.

⁶ See C. Hardy, *Risk and Risk-Bearing Rev. Ed.* (1923).

⁷ "While a futures market is not essential to commodity speculation and has other uses besides promoting speculation, such a market is extremely convenient for the speculation's purposes. Its great advantage is that, until delivery date arrives, the buyer does not have to pay for the goods which he has bought, nor does the seller have to own them." *Supra*, footnote 6, at 206.

⁸ *Supra*, footnote 6, at 223.

⁹ *Supra*, footnote 4, at 7.

¹⁰ Cotton Futures Act, ch. 313 § 3, 39 Stat. 476 (1916).

¹¹ Future Trading Act, ch. 86, 42 Stat. 187 (1921).

¹² Grain Futures Act, ch. 369, 42 Stat. 998 (1922).

the interstate commerce clause of the Constitution, and on this basis was upheld.

The Grain Futures Act of 1922 focused upon the exchanges rather than individual traders and required the exchanges for the first time to be federally licensed or designated as "contract markets."¹³ A condition of the license or designation was that the exchanges would assume primary responsibility for the prevention of price manipulation by their members. Failure to do so resulted in suspension or revocation of the license. The contract markets were given general authority to: Admit members and select officers, discipline offenders and expel members, determine delivery months and contract terms, fix price fluctuation limits, and establish margin requirements, brokerage fees, and commissions. The U.S. Department of Agriculture was charged with responsibility for enforcing the Act, but its regulatory powers were limited and proved inadequate in dealing with market abuses.

After extensive Congressional hearings from 1934 to 1936, Congress amended the law in 1936 and renamed it the Commodity Exchange Act.¹⁴ Regulatory coverage was extended to cotton and other specific commodities, and the Secretary of Agriculture was given broad authority to deal with market abuses by traders as well as exchange members. The amendments authorized the prosecution of price manipulation as a criminal offense, attempted to curb excessive speculation by the large market operator, and extended regulation to the previously uncovered field of commodity brokerage. Coverage under the Act was further extended by several minor amendments between 1936 and 1968.

In 1968, significant changes in the Commodity Exchange Act were approved by Congress.¹⁵ Futures commission merchants (FCM)¹⁶ were required to meet specific minimum financial standards, penalties were increased for certain violations, and the issuance of cease and desist orders was authorized. These amendments required contract markets to enforce their trading rules and contract terms,¹⁷ and extended regulation to cover livestock,¹⁸ livestock products,¹⁹ and frozen concentrated orange juice.²⁰

Following the 1968 amendments there was a major shift to a more market-oriented economy and the futures markets began to play an increasingly important role in the pricing and marketing of the nation's commodities. In previous years, the Federal Government retained large stockpiles of major commodities. When sharp increases in prices began, the Government simply freed the stock, reversing or limiting the price movement and reducing the need for hedging in the futures market.²¹ By 1974, however, large government stockpiles no

¹³ *Supra*, footnote 9.

¹⁴ Commodity Exchange Act, ch. 545, §§ 1-13, 49 Stat. 1491 (1936) (currently integrated into 7 U.S.C. (1976)).

¹⁵ See Act of February 19, 1968, Pub. L. No. 90-258, §§ 1-27, 82 Stat. 26.

¹⁶ A commission merchant is distinguished from a broker in that the commission merchant may buy and sell in his own name without disclosing the principal, and has the goods in his possession. A broker can only buy or sell in the name of his principal and has no possession of the goods sold. See Black's Law Dictionary 339 (4th Ed. 1968).

¹⁷ *Supra*, footnote 15, § 12(b)-(c) (current version at 7 U.S.C. § 7a(8)-(9) (1976)).

¹⁸ *Supra*, footnote 15, § 1(a) (current version at 7 U.S.C. § 2) (1976)).

¹⁹ *Id.*

²⁰ See Act of July 23, 1968, Pub. L. No. 90-418, 82 Stat. 413 (current version at 7 U.S.C. § 2 (1976)).

²¹ See Johnston, *Understanding the Dynamics of Commodity Trading: A Success Story*, 35 A.B.A. Bus. Law 705, 706 (1980).

longer existed. Merchandisers, processors and producers began making greater use of futures markets for hedging purposes and banks became more reluctant to provide loans on unhedged production or inventory. Consumers became increasingly aware of the impact of the futures market on grocery prices and of the need for effective supervision of the market.

Congressional review of the commodity industry in the early 1970's revealed three particular areas where transactions were occurring beyond the reach of state and federal regulation.²² First, the Commodity Exchange Act did not extend to futures trading in agricultural commodities grown outside the United States or to nonagricultural commodities, even though these futures contracts were traded on commodity exchange in the United States.

Second, the fraudulent sale of commodity options²³ had grown to alarming proportions. Although options on commodity futures were banned in 1936 by the Commodity Exchange Act, the ban extended only to options on commodities futures regulated by the Act. In the late 1960's and early 1970's, schemers began taking advantage of the jurisdictional limitations to perpetrate fraud upon investors. Most notable was Harold Goldstein who, in less than two years, pyramided an \$800 initial investment in Goldstein-Samuelson, Inc. into a corporation with world-wide offices valued at \$88 million.²⁴ During this period, investors lost an estimated \$71 million through the fraudulent sale of commodity options not covered by the Act.

EMERGENCE OF "LEVERAGE" TRANSACTIONS

Finally, Congress learned that leverage transactions were not subject to the existing law. Considered by many to be a type of "futures" contract, leverage transactions are defined by industry officials²⁵ as off-exchange agreements for the purchase or sale of a specified commodity—almost always precious metals—at a future date when full payment is made. The principal characteristics of a leverage contract include (1) standard units, quality, and terms and conditions; (2) payment and maintenance of "margin;"²⁶ (3) close-out, after payment in full, by off-setting transactions or by delivery; and (4) no right or interest in a specific lot of the commodity.

Unlike futures contracts, there is no centralized marketplace for leverage transactions and customers are solicited through advertisements, newsletters and telephone calls. The contracts are of unfixed durations with varying delivery plans and rigid margin requirements.

Often viewed as a long-term installment sales contract, these contracts first appeared in the early 1970's with the increasing rise in the

²² See Greenstone, *Leverage Transactions: On Creating A Regulatory Theme*, 27 *Emory Law Journal* 600, 623 (1978).

²³ Options consist of a right, as opposed to an obligation, to buy or sell a commodity at an agreed upon price within a specific time.

²⁴ See Smith, *The Commodity Futures Trading Commission and the Return of the Bucketeers: A lesson in Regulatory Failure*, 57 *North Dakota Law Review* 78-79 (1981). Also, Goldstein was one of many convicted swindlers interviewed by PSI investigators in an effort to obtain first-hand information on commodity schemes and boiler room operations.

²⁵ See Hearings on Commodity Futures Trading Commission Reauthorization Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry, 97th Cong., 2nd Sess., (1982) (Statements by David F. Simon, Lewis Carabini, and James F. Groberg).

²⁶ In leverage transactions, margin is usually interpreted to mean a down payment rather than a security deposit.

silver bullion.²⁷ In 1971, a bag of U.S. silver coins with a face value of \$1,000 had a silver value of \$1,100. Since only a portion of the value, usually 10 percent or \$100, was required as margin, investors began to borrow the face value of a bag of coins and invest it in leverage contracts, i.e. \$1,000 would buy 10 contracts, each requiring a margin of \$100. In this way, the investor gained "leverage" over his investment. By March of 1974, the value of a bag of silver coins had risen to \$4,500. Since banks refused to lend more than the face value of the coins, bag-loan brokers entered the market. These brokers essentially lent the investor a specified dollar amount and charged interest on the loan, usually retaining possession of the commodity as collateral until payment in full was made.

In actuality, the leverage transaction merchant (LTM) seldom owns or acquires the specific commodity at the time of payment but "covers" the agreement by maintaining a long position (hedging) in the futures market. "The customer is generally not advised that the LTM does not own the commodity sold and had no obligation to cover, nor is he informed that cover is secured by the use of customer rather than company funds."²⁸ The leverage dealer acts as a principal and sets the price of every transaction. The dealer does not guarantee a repurchase market and reserves the right to cease operating as a market maker or broker for the customer.

COMMODITY FUTURES TRADING COMMISSION

With every indication pointing to further expansion of the futures market and with growing concern over regulation of the industry, Congress established the Commodity Futures Trading Commission in 1975.²⁹ As an independent agency, the CFTC was charged with administering the Commodity Exchange Act. The Act was extended not only to the previously unregulated commodities, but also to "all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future death in."³⁰ Moreover, the CFTC was granted exclusive jurisdiction over all forms of commodity futures trading, as well as commodity leverage contracts and commodity options. Under the Act, the CFTC, a five member panel, was specifically authorized to regulate certain trading activities in the commodity industry. This authority extended to jurisdiction over the trading of contracts on boards of trade designated as contract markets under the Act (i.e. the national commodity exchanges) and to trading occurring off the exchanges. The Act also authorized the creation of a registered futures association.³¹

Following the 1974 amendments, the trading of futures contracts on financial instruments expanded rapidly. Such trading consisted mainly of short-term commercial paper, mortgaged-backed certificates guaranteed by the Government National Mortgage Association

²⁷ See Greenstone, *supra*, footnote 22.

²⁸ *Id.*

²⁹ See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389.

³⁰ *Id.*, § 201.

³¹ The first registered futures association, the National Futures Association (NFA), was formally approved by the CFTC in September 1981.

(Gennie Maes), Treasury bonds, and Treasury bills. Total trading volume in futures rose from \$32.2 million in 1975 to \$42.09 million in 1977, a 33 $\frac{1}{3}$ % increase in 2 years. The dollar value of commodity trading in futures markets increased to over \$1 trillion in 1977.³²

Due to the rapid expansion of the futures industry and growing concern over the susceptibility of investors to "ponzi"³³ and other fraudulent schemes, substantial amendments to the Commodity Exchange Act were again adopted by Congress in 1978. The CFTC's inability to halt the rampant fraud in commodity options had been highlighted earlier that year in the arrest of Alan Abrahams, also known as James Carr. Despite a lengthy criminal record and escape from a New Jersey prison, Abrahams, who headed Lloyd, Carr & Company, succeeded in obtaining a license in 1976 without investigation by the CFTC.³⁴ As a result of this case and other incidents, most commodity options sales were suspended as of June 1, 1978. The CFTC, subject to a sunset provision in its enacting legislation, came under heavy criticism by Senate and House Committees because of these incidents, but was eventually reauthorized until September 30, 1982.

The Futures Trading Act of 1978³⁵ adopted a more expanded definition of a leverage transaction, reaffirmed the CFTC's exclusive jurisdiction over futures contracts generally and specifically over futures contracts on financial instruments, and clarified the enforcement role of the states. The Act also reinforced the Commission's Regulation 32.11, which suspended commodity option transactions, by imposing statutory prohibitions against the offer or sale of commodity options, except for a limited class of so-called trade and dealer options³⁶ (off-exchange transactions).

The States, although allowed general anti-fraud jurisdiction, were totally preempted by the 1974 amendments from imposing regulatory restrictions on futures trading activities, options or leverage transactions. Under the 1978 amendments, however, they were expressly allowed to sue to enjoin acts and practices where "... the interests of the residents of that state have been, are being, or may be threatened or adversely affected because any person . . . has engaged in, is

³² Supra, footnote 4, at 13.

³³ A "ponzi" fraud is basically a confidence game where investors are lured by the prospect of huge profits on their investments. The fraud is named after Charles Ponzi, an Italian immigrant, who opened offices in Boston in 1919 and sold a get-rich-quick scheme guaranteed to double an investor's money within 90 days. Allegedly purchasing foreign postal coupons at depressed rates and later redeeming them in the United States at higher rates, Ponzi soon took in an estimated \$200,000 a day. Eventually the scheme was exposed by the *Boston Globe*, revealing that early clients were actually being paid from funds of later investors. Ponzi paid off \$15 million of \$20 million he took during his year of operation and served state and federal prison sentences. He was deported in 1934 and died penniless in Rio de Janeiro in 1949.

³⁴ See Greenstone, supra, footnote 22, at 925. Also see Hearings on Commodity Investment Fraud Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, 97th Cong., 2d Sess. (1982) (hereinafter referred to as Hearings) Testimony of Michael Collova.

³⁵ Futures Trading Act of 1978, Pub. L. No. 95-405, §§ 2-23, 92 Stat. 865-876.

³⁶ Congressional efforts regarding the options ban focused primarily on regulations designed to protect the general investing public rather than industry users. As a result, an exemption was allowed for options on physical commodities granted by a "person domiciled in the United States who on May 1, 1978, was in the business of granting options on a physical commodity and was in the business of buying, selling, producing, or otherwise using that commodity," provided that, among other requirements, the grantor maintains a net worth of \$5 million and segregates customer monies. The exemption also permits "grantors and futures commission merchants to enter into, confirm the execution of, any commodity option transaction on a physical commodity subject to (section 4(c) of the Act) . . ." See Futures Trading Act of 1978, effective October 1, 1978, Sec. 3(3), 92 Stat. 865, 867-869.

engaging or is about to engage in, any act or practice constituting a violation of any provision of this Act or any rule, regulation, or order of the Commission thereunder . . .”³⁷ However, Congress limited the basis for such actions to federal law and designated the federal courts as exclusive forum for these cases. Local prosecutors could resort to several anti-fraud provisions but state securities commissioners could not utilize their Blue Sky laws to protect resident investors. States were specifically prohibited from taking any action against contract markets or floor brokers designated or registered by the CFTC.

Since the 1978 amendment, Congressional interest has remained constant with regard to commodities and especially futures trading. Concern over the sudden rise and decline in silver prices during August 1979 through March 1980 and the maintenance of substantial concentration in silver futures by several market participants, e.g., W. Herbert Hunt and Nelson Bunker Hunt, led to Congressional hearings in the spring of 1980.³⁸ Later the same year, Congressional hearings were held to assess the impact on U.S. farmers of the Soviet grain and technology embargo imposed in December of 1979,³⁹ following the Soviet invasion of Afghanistan.

In addition, Congress in recent years has examined a wide variety of other commodity-related issues, such as tax straddles,⁴⁰ margin requirements,⁴¹ investment fraud directed at the elderly⁴² and, most recently, further reauthorization of the CFTC.⁴³

OVERVIEW OF PSI INVESTIGATION AND HEARINGS

The Permanent Subcommittee on Investigations generally limited its scrutiny of the commodities industry to the sale of commodity and commodity related instruments not traded on the 11 exchanges approved by the CFTC. This “off-exchange” trading is not subject to the rules of any particular exchange and, as a result, is more vulnerable to abuse.

A substantial portion of the Subcommittee’s investigation involved operations known as “boiler rooms,” which consist of a group of telephone salesmen who make unsolicited calls to unsuspecting individuals and employ hard sales tactics in order to coerce the customer into a

³⁷ Id., § 15 (current version at 7 U.S.C. § 13a(2)).

³⁸ Hearings on CFTC Regulatory Authority Review Before the Subcommittee on Conservation and Credit of the House Committee on Agriculture, 96th Cong., 2nd Sess. (1980); Hearings on Silver Prices and the Adequacy of Federal Actions in the Marketplace Before the Subcommittee on Commerce Consumer and Monetary Affairs of the House Committee on Government Operations, 96th Cong., 2nd Sess. (1980).

³⁹ Hearings on the Suspension of U.S. Exports of High Technology and Grain to the Soviet Union Before the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2nd Sess. (1980).

⁴⁰ Hearings on Commodity Tax Straddles Before the House Committee on Ways and Means, 97th Cong., 1st Sess. (1981); Hearings on Commodity Tax Straddles Before the Subcommittee on Taxation and Debt Management and the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance, 97th Cong., 1st Sess. (1981).

⁴¹ Hearings on Margin Requirements for Transactions in Financial Instruments Before the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2nd Sess. (1980).

⁴² Hearings on Fraud Against the Elderly Before the Subcommittee on Retirement Income and Employment of the House Select Committee on Aging, 96th Cong., 2nd Sess. (1980); Hearings on Fraud Against the Elderly: Business and Investment Schemes, Before the House Select Committee on Aging, 97th Cong., 1st Sess. (1981).

⁴³ Hearings on CFTC Reauthorization Before the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture, 97th Cong., 2nd Sess. (1982); Hearings on CFTC Reauthorization Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry, 97th Cong., 2nd Sess. (1982).

quick sale. These operations cloak themselves with impressive names, addresses and bank references, and thereafter attempt to browbeat the customer with seemingly unending reasons to invest.

The Subcommittee also looked at firms which, while operating legitimately themselves, acted as training grounds for new operators who would later create and run schemes designed to fleece their customers.

The Subcommittee investigated the problem of off-exchange commodity fraud for more than eight months. In order to familiarize themselves with the problem, investigators spent a great deal of time at the offices of the CFTC in Washington and New York. While cautiously avoiding interference with on-going law enforcement investigations, Subcommittee investigators undertook an exhaustive review of past cases that had been handled by the Commission. Numerous CFTC employees were interviewed and proved helpful to Subcommittee investigators in explaining the mechanics of commodity regulation. In the Enforcement Division, investigators and litigation undertaken by the CFTC were reviewed. Resources were also allocated to study the Commission's Reparations Section and Registration Unit.

Using complaints made to the CFTC, registrations with the CFTC, complaints to state securities commissions, and civil and criminal actions, Subcommittee investigators attempted to identify the individuals who had continually been involved with and responsible for operating the most notorious commodity scams. The Subcommittee discovered and interviewed individuals who had operated and abandoned as many as 10 different commodity schemes each. A detailed history of some of the most blatant violators of commodity laws was then assembled. Since this type of intelligence had not been compiled previously, the Chairman has begun to make the compilation available to law enforcement agencies and the Senate has approved S. Res. 373 in this regard. The operations and associations of these individuals suggest that an elite group of organized criminals can be found to be responsible for some of the most extensive commodity fraud operations to date.

During the time of the Subcommittee investigation into commodity fraud, the Government Accounting Office (GAO) was conducting a review of the CFTC for its reauthorization in the spring of 1982. Subcommittee and GAO investigators met on several occasions in an effort to avoid duplication of work. Subcommittee investigators were also in contact with officials from the Postal Inspection Service and the Department of Justice. Each agency has evidenced a continuing concern over commodity fraud and proved cooperative.

In order to obtain input from the states, the Subcommittee wrote to 40 state securities commissioners and attorneys general. The Subcommittee also contacted 30 receivers appointed by the courts in cases involving commodity fraud. The state authorities were asked a series of questions involving the extent of commodity fraud in their respective states and their experiences with the CFTC. They were also requested to share their views on how commodity regulations could be made more effective. The responses of the state authorities were useful in determining nationwide patterns and problems.

The receivers⁴⁴ were asked similar questions, as well as questions concerning the extent of the fraud in their particular cases. From these responses, the Subcommittee was able to extrapolate the extent of customer losses stemming from commodity investment fraud schemes. The receivers, through their depiction of various schemes, were able to paint a vivid picture of the development of commodity fraud operations.

At various points during the investigation, staff members, in order to fully understand the illegitimate commodity industry, found it useful to discuss issues affecting the legitimate commodity industry. Thus, Subcommittee staff members met with exchange officials and representatives of various organizations representing the interests of legitimate commodity operators.

Finally, a large number of victims of commodity schemes were contacted to determine how their money had been taken. Conversely, various persons convicted of operating commodity schemes were interviewed by Subcommittee investigators, both in and out of prisons.

In order to obtain firsthand experience, Subcommittee investigators located the offices of telephone sales operations involving commodity related instruments and made unannounced visits. While some of the firms appeared to be legitimate, Subcommittee investigators found that many of the firms were highly suspect in their dealings. Several subpoenas were issued, including one to a firm against which the CFTC obtained an injunction on February 26, 1982.

During the Subcommittee hearings, a total of 22 witnesses testified before the Subcommittee, in addition to Subcommittee investigators. Several victims of commodity fraud schemes expressed particular concern over the lack of information available to consumer-investors regarding the legitimacy of investment firms, and the complicated, time-consuming procedures employed by the CFTC Reparations Unit in accepting and processing investors' claims. Commodity fraud defendants, convicted for their participation in various schemes, discussed the ease with which boiler room operations could be established, while court-appointed receivers noted the lack of clearly defined authorities and responsibilities, and the difficulty of finding tangible, solvent assets which could be returned to victim investors.

The General Accounting Office similarly expressed concern over current CFTC procedures regarding reparations and registration, as well as audits and financial surveillance capabilities. State securities and law enforcement officials noted frustration with the jurisdictional restrictions imposed by federal preemption of state regulation and the apparent failure of the CFTC to effectively control boiler room operations. A representative of the National Association of Future Trading Advisors indicated support for expanded state jurisdiction in off-exchange commodity fraud cases. Finally, the Chairman of the CFTC appeared to present the views of the Commission and to respond to questions by the Members.

⁴⁴ A receiver is "an indifferent person between the parties to a cause, appointed by the court to receive and preserve the property or fund in litigation, and receive its rents, issues, and profits, and apply or dispose of them at the direction of the court when it does not seem reasonable that either party should hold them." See Black's Law Dictionary 1433 (4th Ed. 1968).

FINDINGS AND CONCLUSIONS

COMMODITY INVESTMENT FRAUD IN THE UNITED STATES

The Subcommittee's review of off-exchange commodity fraud transactions revealed numerous illegal operations of varying degrees of sophistication which target investors seeking ways to hedge against high inflation. These investors have few ways of verifying the legitimacy of a firm—much less a salesman's character and reputation—and, once defrauded, have little chance of recovering their investments. Although the CFTC has been given exclusive jurisdiction over commodity futures trading, the agency is thoroughly out-gunned in the ongoing battle against commodity fraud. States eager to assist federal regulators are confronted by federal statutory restrictions, jurisdictional conflicts and frustrating delays resulting from the CFTC's lack of manpower. Meanwhile, the newly created self-regulatory authority, the National Futures Association, remains in the fledgling stage and faces renewed threats to its very existence.

THE BOILER ROOM OPERATION

Through its extensive examination of commodity investment fraud schemes, the Permanent Subcommittee on Investigations discovered a multitude of organized criminals who bilk the American public out of hundreds of millions of dollars each year. Unwary investors are continuously lured into commodity related schemes where most, if not all, of their money is stolen. These investors are not victims of poor market performance, but rather fall prey to unscrupulous con men who falsely claim to operate legitimate commodity trading firms.

In actuality, these "firms" usually consist of rented rooms crammed with desks and phones. Salesmen are hired for their brazen persistence alone; no actual knowledge of commodities is necessary. In fact, the less a salesman knows about a product the less restrictions are on him while speaking to customers. Consequently, salesmen receive little training and even less supervision. Salesmen learn to think of prospective customers as "mooches," holding money in their pockets which should be in the salesmen's pockets. As a result, they often make blatant oral misrepresentations and twist facts as they see fit, negating the importance of written representations later sent to the investor.

The key to selling a non-existent product to a perfect stranger is to build the excitement of the prospective sale to a feverish pitch. A very large sale is considered a great accomplishment, enhancing the status of the salesman in the eyes of his peers. There is a great deal of money involved. Salesmen's commissions can run as high as 50 percent of the sale. In this particular industry, a single sale of \$10,000 is common and sales as high as \$100,000 are not unheard of. Thus, one successful telephone call by a salesman can yield thousands of dollars. The use of stimulants, including amphetamines and cocaine, is prevalent.⁴⁵ Salesmen are packed into these so-called "boiler rooms," shoulder-to-shoulder, in order to feed off the excitement of another salesman's successful

⁴⁵ Hearings, Statement by Kenneth Levin, p. 19.

sale. Often two or more salesmen will be on the phone with the same client in order to wear down any resistance the customer may offer. Prepared sales pitches are read, sometimes verbatim, and responses to customer objections are indexed to provide a prompt rebuttal. The best salesmen will be employed as "loaders" and will recall previous customers in order to try to sell even more of the worthless contracts.

Some boiler rooms even have multilingual capabilities. For example, PSI investigators got into the Boston telephone room of a registered commodity trading advisor (CTA) and found a salesman pitching a customer in Chinese.

High commissions, high telephone costs, flagrant misrepresentations, and the ever-present greed of the principals combine to ensure that little, if any, of the customers' money will actually be invested in commodity futures. The date the contract comes due—usually six months to one year after the sale—frequently corresponds closely to the time the company disappears. Meanwhile, the assets have been hidden, the sales staff has slipped away to other boiler room operations, and the principals have begun to devise new angles to old schemes, moving their operations to new havens. Customers will be extremely lucky to recover any part of their investment.

Orestes Mihaly, Assistant Attorney General in charge of the Bureau of Investment Protection and Securities of the State of New York, estimated that over 100 boiler rooms come and go in New York City during the course of a year. Mr. Mihaly told the Subcommittee:

(T)hese boiler rooms proliferate like the mythical hydra (where you cut off one head and 10 heads appear the next week). Individual boiler rooms may gross in excess of \$10 million a year. While this amount is not the average, there is little doubt that there are tens of millions of dollars stolen from the public annually in New York alone. That national figure is even more staggering.⁴⁶

There is also evidence that organized crime elements are involved in these kinds of operations. In response to a question by Chairman Roth, Alabama State Securities Commissioner Thomas L. Krebs stated:

It is not unlikely they are Senator. The risks are very few. It is easy to do, and a great deal of money to be made. It has been our experience (that) where those factors come (into) play, when they all coalesce, yes, you have organized criminals.⁴⁷

Even more adamant, Miami Postal Inspector Norris Penland told the Subcommittee that commodity fraud is one of the most prevalent organized criminal activities in his state:

Next to drugs, . . . I believe white collar crime, or more specifically commodity investment fraud, is probably the most lucrative industry. Money derived from (these) ventures has quickly spread into other areas, such as drugs, into foreign markets out of the jurisdiction of the United States.⁴⁸

⁴⁶ Hearings, p. 41.

⁴⁷ Hearings, p. 44.

⁴⁸ Hearings, p. 52.

Commodity fraud firms may concurrently operate other illegal operations, using the steady flow of "investor" monies to finance illegal activities. For instance, in 1979, Jack Savage, a veteran of several commodity schemes, set up the Pyne Commodity Corporation. The following year, Pyne Commodity and its principals, including Savage, were sued by the CFTC for fraud (*CFTC v. Pyne Commodities Corp.* Civ. No. 80-3952 (S.D.N.Y. 1980)) and a receiver was appointed to return customer monies. Of the \$1.5 million taken in by Pyne, only a small amount was recovered.

On February 9, 1982, Jack Savage was indicted by a federal grand jury in Ft. Lauderdale, Florida, for allegedly using Pyne Commodities Corporation to import and store huge quantities of marijuana and cocaine. Savage and Pyne Commodities reportedly warehoused hundreds of thousands of pounds of marijuana and undetermined amounts of cocaine. Meanwhile, Savage cannot be located.

It was also discovered that, while the commodity recidivist problem was widely suspected throughout the industry, no compendium of repeat offenders had ever been compiled.⁴⁹ Although the CFTC and other agencies had lists of the individuals sued and convicted in commodity fraud schemes, it became obvious that these lists contained only the tip of the iceberg.

Subcommittee investigators, using CFTC registration and complaint files, records from various law enforcement agencies, and public record documents including injunctions and indictments, assembled a file of recidivists which included hundreds of company and individual names. From this information, the Subcommittee was able to identify an elite cadre of commodity fraud recidivists who had created and operated countless schemes taking in tens of millions of dollars. Numerous individuals were found to have been principals of or associated with several firms during the past five years.⁵⁰ Boiler room operations seemed to hold a particular attraction for these individuals. An example of this interrelationship between the principals and the salesmen of some of the more notorious firms was charted by the Subcommittee and presented at the commodity fraud hearings (Hearing Exhibit No. 3). Rarely were these individuals indicted; substantial customer recoveries were similarly unlikely.

The Subcommittee found that many of these recidivists had learned the commodity business while employed with firms of questionable legitimacy. Once they had learned the business, they assumed supervisory roles or started their own companies. Generally speaking, little experience in commodities or formal education is required to set up

⁴⁹ Some limited compilation has been done, but only to a parochial extent. For example, the Leviticus Project is an association of several state law enforcement divisions which combats crime in the coal industry of the Appalachian region. Information is assembled and shared, but would only involve any recidivist who had been involved in commodity schemes which dealt in some way with coal. See *infra*, footnote 94.

⁵⁰ In statements before the Subcommittee, Robert Shoher, convicted for fraud in his involvement with New Era Precious Metals, Corps., admitted to past associations with 15 separate companies, nine of which he either owned, in whole or in part, or acted as a principal. This list included: Atlantic Coast Silver Exchange (principal); American Currency Exchange (principal); Chartered Systems of New York, Inc. (employee); Crown Colony Commodity Options (employee); First Real Commodities Co. (part owner); International Metals Exchange (part owner); International Monetary Marketing, Inc. (owner); London Commodity Options (employee); New Era Oil Development (part owner); New Era Precious Metals (part owner); Propper International Equities (employee); R.T.&J Trading Corp. (part owner); Sabine Oil Exploration (part owner); United States Petroleum Exchange (employee); and Williston Trading Corp. (employee). See Hearings, p. 58-60.

these operations, and virtually no qualification standards have been established by the CFTC. Some of the more notorious operators have been high school teachers, electricians, vending machine servicemen and disc jockeys.

Attorneys Edward Dangel and Eugene Fleming, appointed by federal courts to serve as receivers and to marshal the assets of certain defunct commodity fraud operations, have found that the vast potential profits of commodity fraud seem to outweigh possible prison time in the minds of most commodity fraud operators. For example, according to Dangel, a scam operator who steals \$3 million and receives a five year prison sentence simply equates that to a \$600,000 a year income.⁵¹ Fleming discovered that one defendant had compiled actual tally sheets where the proceeds from a commodity fraud operation were compared to the number of months in jail that might result from a conviction. Fleming also discovered a book entitled, "Stealing From the Rich: The Home-Stake Oil Swindle" by David McClintock.⁵²

A SOPHISTICATED SCHEME

The lucrative nature of these schemes was perhaps best demonstrated during the hearings by the case of Richard Waggoner. In 1975, Waggoner graduated from California State College and, with a degree in comparative literature, took a job as a student teacher at a high school. While a student teacher, Waggoner apparently read a book on commodity trading and became fascinated by the subject. In 1976, he became a salesman for Economic Systems, Inc., a company selling London option contracts.⁵³ Within a short time, Waggoner was making \$5,000 to \$6,000 a month in commissions selling London options over the telephone. Waggoner later became a partner in the firm when he succeeded in attracting a wealthy client whom he eventually managed to defraud of \$12,000,000.⁵⁴ Waggoner registered with the CFTC from 1975 until 1977, but failed to attempt to register thereafter.

In 1978, Waggoner decided to branch out by selling commodity contracts involving currency. He created Systems Monetary Internationale (SMI), an elaborate operation with Luxembourg bank accounts, a Panamanian supplier, and several telephone sales banks for nationwide solicitation of sales. Unfortunately, SMI was a "ponzi" operation in which only 10% of the customer's money went as a down payment on the contract, while the remaining 90% went to SMI as a "service fee".⁵⁵ By 1978, SMI had sold over 900 contracts and had taken in over \$3 million.⁵⁶

Waggoner, however, envisioned even larger and more profitable operations. Thus, in early 1979, he purchased a Panamanian corporation from a London law firm for \$2,000⁵⁷ and created a scheme for selling oil futures, a vastly complicated field in which Waggoner knew the CFTC had little expertise. Waggoner christened his new

⁵¹ Hearings, p. 86.

⁵² Hearings, p. 91.

⁵³ London Options are commodity options traded on the London market. For more information see Smith, *supra*, footnote 24, at 22-30. Also see, Hearings, p. 22.

⁵⁴ Hearings, p. 22.

⁵⁵ *Id.*

⁵⁶ Hearings, p. 23.

⁵⁷ Hearings, p. 26.

corporation Comercial Petrolera Internacional (CPI), and entered into a partnership with Panamanian nationals who established a false history of CPI in Panamanian banks. By paying a bribe, a fake Dun & Bradstreet report was obtained which valued CPI at \$14,117,000. Waggoner then brought in Edwin Bederson, with whom Waggoner had worked at SMI, to act as agent for CPI. Bederson insulated himself by forming the International Petroleum Exchange in Manhattan to be the exclusive marketing agent for CPI. He then recruited his former boiler room colleagues, Kenneth Levin and James Morse, who established the Bartex Petroleum Corporation to wholesale CPI crude oil contracts and to set up and train retailers. In all, twenty-seven retail companies were subsequently formed in either states, with a base in New York City (Hearing Exhibit No. 4). Each of the retail companies, under the direction of Bartex, set up high pressure telephone operations which, in less than one year, took in over \$4 million from 600 sales nationwide.

This entire elaborate network was a fraud. The oil which the retailers, wholesalers, agent and suppliers supposedly were selling did not exist. CPI never bought nor made any real commitment to buy oil. CPI had no capacity to store or ship oil. The grade of oil offered by CPI, "27-34 API", was a product of Waggoner's imagination, as were his daily price reports. The Panamanians simply cranked out fictitious telex notices from their Panama City office "confirming" oil prices. Of the money taken in, half was kept by the retailers, 10% was absorbed by the wholesalers, and the agent skimmed his percentage from the remaining amount. The money that was left was divided between Waggoner and his Panamanian partners.⁵⁸ No money was ever used to cover the contracts.

It is still unclear how many persons involved knew how fraudulent the entire network actually was. While some operators may have been as duped as the customers, others knew, suspected or didn't want to know. Ken Levin, a principal of Bartex, knew by at least November of 1979 that the entire operation was a fraud.⁵⁹ By that time, however, the customer money was pouring in and Levin chose to continue operating, earning, by his admission, over \$120,000 that year. Levin's telephone expenses were as high as \$1200 per salesman per month. Salesmen's commissions ran as high as 40 percent of the total amount which the customer sent in to secure his contract. Most salesmen didn't know, didn't ask and didn't care if the operation was legitimate.⁶⁰ The operation was brazen and immensely profitable. Even when the State of New York issued a cease and desist order against, Bartex Levin attempted to move to another state and continue selling the worthless oil contracts.

In 1981, in the U.S. District Court for the Southern District of New York, the CFTC and the New York State Attorney General filed a joint complaint against some 64 persons and firms connected with CPI. Permanent injunctions were eventually obtained against most of the defendants, but Waggoner was so well insulated that the civil

⁵⁸ At the Hearing, during questioning by Senator Sam Nunn. Kenneth Levin indicated that the use of offshore banks to launder and secrete moneys obtained through commodity scams is commonplace. See Hearings, p. 32-33. The Subcommittee plans to pursue these offshore issues in further investigations.

⁵⁹ Hearings, p. 18.

⁶⁰ Hearings, p. 19.

investigators never realized he was involved. Subsequent criminal action resulted in the convictions of Bederson, Levin, Morse and Waggoner and indictments are still outstanding against two Panamanians.

Although CPI and its subsidiaries have since been put into receivership, less than \$400,000 of the estimated \$4 million received by CPI has been recovered. Edward Dangel, the receiver for CPI, noted that "most of the money, almost all of it, had disappeared by the time (I) was appointed and, therefore, a good deal of my effort has been involved (in) obtaining the necessary funding in order to chase people as far as Panama."⁶¹

THE ELEMENTARY APPROACH

A commodity fraud operation need not be expansive, international or complex to attract millions of customer dollars. In 1969, Raymond Day, a high school graduate with no real skills, was discharged from the Army after 5 years of active service. Returning to his native New York City, Day began supporting himself by soliciting telephone sales for an electronics company. Over the next few years, Day drifted from one telephone sales job to another, selling electronics, furniture and chemicals. In 1975, he obtained telephone commodity sales jobs with the Bristol Options Company and the Williston Corporation, but was later convinced that both operations were fraudulent and quit.

Through his various telephone sales jobs, Day was able to acquire some trading experience and, in 1977, he attempted to establish his own company. He set up a telephone sales operation for diamonds, but it did not succeed. Day then returned to commodity sales and obtained a supervisory position at the firm of Fairchild, Arabatzis and Smith, in New York. During this time, Day witnessed high pressure sales and gross misrepresentations, and encountered customers who lost all of their investment. At the same time he observed Fairchild, Arabatzis and Smith raking in astounding amounts of money. He left the company shortly thereafter, before civil and criminal actions were taken against the firm's principals. A court-appointed receiver of the company later determined that almost 1300 people in 45 states had lost more than \$6 million in investments with the firm.

Undeterred, Day left to create his own commodity sales operation which he called Archaray Enterprises. With an initial investment of \$900 and three telephones in a rented room, Day began selling "deferred delivery" contracts on gold, silver and oil. The operation quickly met with great success and money began rolling in. By all indications, Day had originally intended to cover his contracts, but he quickly fell behind and had to divert incoming money to pay off old accounts. Customer investments, wired directly from the customers banks, were soon coming in at the rate of \$200,000 a week.⁶²

Within a year, Archaray had grown to over 50 salesmen in several different offices, but the operation itself had gotten completely out of hand. Salesmen, obtaining 50% commissions, would brazenly lie to customers. Contracts were not covered. In September of 1979, the FBI raided Archaray. Day was subsequently indicted and pled guilty to 12

⁶¹ Hearings, p. 85.

⁶² Hearings, p. 77.

counts of fraud and one count of illegally selling options. By this time, Archaray had taken more than \$2.5 million from 270 customers in 41 states. Only \$462,000 was recovered. Ironically, had Archaray purchased the contracts as it promised, those contracts would have been worth over \$19 million to the investors.⁶³

Through its investigation, the Subcommittee learned that (multi-thousand dollar) investments, such as those made with CPI and Archaray, are not uncommon; hence boiler rooms which have operated for only a few months may take in millions of dollars.⁶⁴ If law enforcement agents are able to act quickly enough, some of the investors' money can be recovered. More often, however, most or all of the money is lost.

THE VICTIMS

It has been said that the victims of these schemes are avaricious fools and, as such, are impossible to protect. Such statements are as inaccurate as they are callous. "Those who feel that defrauded investors brought it on themselves are naive," according to Mark Tepper, an assistant New York State Attorney General in the Department of Investor Protection and Securities.⁶⁵ Fraud operators are criminals who have numerous ways of manipulating their victims.⁶⁶ They seek out and exploit any area in which the victim may be vulnerable. The most typical victims are the retired individuals who fear inflation will overrun their limited income and who seek ways to hedge their savings.

George Connor of Quakerstown, Pennsylvania, is one such individual. Retired, Mr. Connor was looking for a hedge against inflation. Mr. Connor was telephonically contacted by a salesman from the Consolidated Gold and Silver Company in Miami, Florida, and was convinced by a high pressure pitch to invest some \$90,000 over a one year period in a "gold deferred payment plan." The company disappeared and Mr. Connor ended up losing over \$77,000.⁶⁷ He and his wife have since been forced to move from their home to a mobile home park.

Mrs. Pauline Hazebrouck of Woonsocket, Rhode Island, is another elderly person who attempted to obtain economic security from investments which later proved to be worthless. After some unsuccessful commodity investments, Mrs. Hazebrouck was contacted by several different companies which convinced her to invest in such areas as manganese, cobalt, silver, Mexican pesos, and copper. She was bounced from one firm to another, including Prime Precious Metals, Premium Precious Metals, Prime Strategic Metals, and Strategic Metals International, all owned and operated by the same individuals. In all, Mrs. Hazebrouck made 13 separate investments totalling \$88,122. Whenever she attempted to close or sell the contracts she was told that this was not possible.⁶⁸ Today the companies have been closed by the CFTC and Mrs. Hazebrouck is not expected to recoup much of her investment.

⁶³ Hearings, p. 76.

⁶⁴ Bobby Howell, operating Jefferson National Investment Corporation, took in over \$2 million in less than one year. (Hearings, p. 79.) Raymond Day took in \$2.5 million in one year. (Hearings, p. 75.) Richard Waggoner sold worthless contracts for over \$4 million in less than one year. (Hearings, p. 25.) All three are currently serving federal prison sentences. Wilbert Wilson, who ran Ashton & St. Johns Commodity pool, took in \$3,750,000 over two years. He has since been indicted and is a fugitive. See letter from Stephen E. Kaufman to Senator Roth, December 4, 1981, (Hearings, Exhibit 10).

⁶⁵ New York Weekly Spotlights on Metals, November 27, 1982, at 1.

⁶⁶ In fact, commodity fraud operators are themselves often deceived by other commodity fraud operators. Richard Waggoner, mentioned above, was himself swindled out of \$3 million in a commodity scam. See Hearings, p. 30-32.

⁶⁷ Hearings, pp. 4-5.

⁶⁸ Hearings, p. 8.

The victims of these commodity fraud schemes are not, however, limited to older or less sophisticated individuals. David Schonbach, a 34 year old computer consultant with a Ph. D. in electrical engineering, was interested in trying different investments and was told by a salesman from the Connors and Davenport Corporation that he could get his whole investment back at any time. After an unsuccessful attempt at verifying the legitimacy of Connors and Davenport with the CFTC, Schonbach sent the firm \$7,415.⁶⁰ Mr. Shonbach never saw his money again. Connors and Davenport is currently out of business.

Another victim of commodity fraud, Richard MacMillan of Hudson, New Hampshire, is the owner and operator of a plumbing and heating contracting firm. Mr. MacMillan repeatedly received unsolicited telephone calls from the International Trading Group (ITG) which attempted to interest him in oil and silver futures contracts. After calling the CFTC and learning that ITG was duly registered, MacMillan wired \$1,750 to ITG. ITG later defaulted on the contract. Although Mr. MacMillan has obtained a default judgment against ITG, the firm is no longer in existence.⁷⁰

The Subcommittee also learned that "people who have lost money in previous commodity deals are (viewed as) excellent prospects for future sales"⁷¹ because it is generally believed that they are eager to make up their past losses. As a result, customer lists are valuable and are frequently sold to other operators for substantial sums.⁷²

REGISTRATION: THE ILLUSION OF LEGITIMACY

What has lent an air of legitimacy to these commodity fraud operators is the fact that they and their firm may be registered with the CFTC. The Commodity Exchange Act requires "that any individual or firm dealing in, or advising about, commodity futures trading register with the Commission . . . Because of the nature of the responsibilities assumed by a person in a registered capacity, the Commission must conduct an extensive investigation of the fitness and qualifications of each person who files (for registered) . . ."⁷³ In reality, the registration process at the CFTC does little to prevent undesirable individuals from being registered, and is often used to convince customers that the firm is legitimate.

There are currently over 50,000 persons registered with the CFTC in some capacity. Over the last three fiscal years the Registration Unit has granted an average of 13,000 initial and 16,500 renewal registrations each year. The CFTC has 17 persons to handle all registration, investigations, inquiries, fee collection and clerical work. The majority of these persons are GS-5 clerks who review the applications for registration.

Although the Registration Unit has computer capabilities to review applications, the system was designed nine years ago and has proven to be antiquated. While performing a basic filing function, the computer has no capacity to detect even the simplest form of deception that a knowledgeable applicant could utilize and there is no centralized system to correlate information gathered by other CFTC divisions.

⁶⁰ Hearings, pp. 6-7.

⁷⁰ Hearings, pp. 95-105.

⁷¹ Hearings, p. 19.

⁷² Id.

⁷³ Commodity Futures Trading Commission Annual Report 1980, at 127-130.

Applications are processed through the CFTC office in Chicago. Problem applications are forwarded to the Washington office, which is composed of three investigators, two support person and an assistant director. At any given time, these three investigators must handle 350 cases, with an additional 50 investigations being contracted out to other federal agencies. Subcommittee inquiry revealed that CFTC Registration investigations take about six months to complete and only an estimated 2 percent of all investigations result in the issuance of an order denying registration.⁷⁴

THE EFFECTIVENESS OF REGISTRATION

The effectiveness, or lack thereof, of the current registration system was addressed in a letter to Chairman Roth from Michael Unger, Director of the Securities Division of the Massachusetts Office of Secretary of State, dated January 5, 1982. Mr. Unger noted, "A reoccurring problem has been the discovery that individuals become licensed by the CFTC although the applications are incomplete or misleading. It is apparent that there is inadequate review of license applications by the CFTC."

Further investigation revealed a myriad of ways by which CFTC registration requirements have been avoided. The use of aliases is commonplace.⁷⁵ One registered person may allow other persons to use his name in representations to the public.⁷⁶ Often times, a wife or a friend is registered with the CFTC, while the operation is actually run by an unnamed person who avoids registration altogether.⁷⁷ These hidden principals, usually paid as consultants, create the scheme, hire the salesmen, run the operation and in return, receive most of the profits from the venture.

Michael Collora, a former Assistant U.S. Attorney who has handled several large commodity fraud cases, told the Subcommittee that currently there is no registration process of any meaning for commodity futures salesmen. Collora further stated that convicted felons, often using aliases, continually drift from one boiler room to another.⁷⁸ Other state officials expressed similar concern over recidivism among commodity fraud operators.⁷⁹

⁷⁴ Alarmingly, the CFTC is attempting to avoid even this small percentage of registration denials. In a March 4, 1982 statement to the Futures Industry Association, CFTC Chairman Philip F. Johnson noted, "We want to issue conditional registrations rather than deny registrations to those who can be expected to perform well under closer supervision or other guidelines." Such a practice will dilute the small degree of progress made by the registration unit in recent years.

⁷⁵ Hearings (Statements by Robert Shohar, Raymond Day and Richard Waggoner).

⁷⁶ During an interview with PSI investigators, Raymond Day commented that following the imposition of CFTC registration requirements for associated persons (APs), including filing deadlines, a serious backlog of applications resulted. In an attempt to keep working during the time it took the CFTC to process the application, many individuals "arranged" with registered APs to use their names in the interim period.

⁷⁷ Subcommittee investigators discovered that convicted swindler Kenneth Levin's wife had been registered with the CFTC, despite the fact that she had virtually no knowledge of the status of the company. In response to questioning, Mrs. Levin noted that "Kenny takes care of the business." See Hearings, pp. 36-37, 119. Also, Maria Pepe, wife of Tom Pepe, enjoined by the CFTC for his involvement with Republic Advisory Corporation, was registered as a principal with that same corporation. See *CFTC v. Republic Advisory Corporation*, Civil No. 81-1189 (D.N.J. 1981).

⁷⁸ Hearings, p. 48.

⁷⁹ "There is no question that the particular criminal subculture involved in commodities fraud has been active in other commodities ventures as well as in securities schemes." Letter from Paul J. Roshka, Jr., Assistant Director of the Arizona Corporation Commission, to Senator William V. Roth, Jr., December 4, 1981. "(My) staff has detected facts leading to the conclusion that different fraudulent conduct has been perpetrated by the same individuals." Letter from Richard R. Malmgren, Commissioner of Securities, State of Wisconsin, to Senator William V. Roth, Jr., January 15, 1982. "Many of the principals in

PSI investigators found one individual, Bernard Bauman, who is the subject of complaints to the CFTC involving five different firms, all of which have been enjoined for trading violations. Despite these facts, Bauman is currently registered with the CFTC as an associated person, and is acting as a supervisor of an active commodity telephone sales operation, Chartered Systems of Miami, Florida. When asked by PSI investigators if he knew of his employee's history, the manager, Sheldon Yablon, replied, "If he can get registered, then he's all right by me."⁸⁰

The thoroughness of the CFTC registration checks was brought into even more serious question, however, during the testimony of Henry Eschwege, the Director of the Community and Economic Development Division of the General Accounting Office (GAO), who had conducted an extensive investigation of the CFTC for purposes of the 1982 reauthorization hearings. During that investigation, GAO discovered that the "CFTC does not periodically check registrants against FBI or Securities and Exchange Commission files."⁸¹ In fact, Eschwege noted, the CFTC does not regularly check its own records to determine whether the registrant has committed acts which would render him unsuitable for registration.⁸²

LACK OF FINGERPRINTING

In 1978, Section 8a of the CEA was amended to allow the Commission to require the fingerprinting of applicants for more effective registration screening. It has been four years since this authorization and no legislations have yet been implemented. As the system currently exists, a simple alias can thwart any protection otherwise provided by the Registration Unit. For example, Subcommittee investigators found one individual who had worked for seven different boiler rooms under the names: Bob Leeds, Tony Ross, Bob Roma, and—particularly disturbing to the Chairman of the Subcommittee—William Roth.

Fingerprinting is a sound means of determining that the person is who he purports to be, and the CFTC has the power to implement rules to require fingerprinting of registered persons. The CFTC, however, has not implemented such rules.

As it became clear that the registration process does not ensure honest salesmen, the Subcommittee became curious as to whether these persons were at least competent to deal in the complex world of commodities. A review of existing procedures revealed that there are no standards required by the CFTC which even attempt to ensure that the registered person handling a commodity transaction knows what he is doing. Section 4p of the Commodity Exchange Act (1974) provides that the Commission may prescribe "written proficiency examinations" to ensure the fitness of registered persons. Such examinations

the companies currently under investigation have criminal records, have been the subject of SEC proceedings or have been involved in boiler room operations in the past, whether in securities or commodities." Letter from Edwin M. Walker, Director, Tennessee Department of Insurance to Senator William V. Roth, Jr., January 28, 1982. "The potential lucrativeness of a successful commodity boiler room scam, the inadequacy of government resources to combat commodities fraud, the low risk with respect to criminal prosecution, conviction and jail time, combine to attract repeat offenders." Letter from Michael Unger, Director, Securities Division, Massachusetts, Secretary of State, to Senator William V. Roth, Jr., January 5, 1982. Correspondence entered into Hearing Record as bulky Exhibit 9 (unpublished).

⁸⁰ Statement by Sheldon Yablon to PSI investigators, October 2, 1981.

⁸¹ Hearings, p. 107.

⁸² Id.

would require registered individuals to have a sufficient understanding of the industry and would provide a means of setting competency levels for the industry. Eight years later, however, no proficiency examinations have been implemented, nor are any serious steps being taken for such implementation. As it now stands, even if registration could ensure a registered person's good character—which it can not—there is no guarantee that even the honest registered person has an adequate understanding of the commodity business.

The CFTC has also examined the possibility of adopting suitability standards comparable to the "know your customer" rule in the securities industries, but no such rule has been adopted. "The result of this is that unsophisticated investors are pressured into placing all or a major part of their savings into a highly speculative market as a consequence of representations that they are certain to receive spectacular returns on the investment."⁸³

TOUTING REGISTRATION

An additional concern raised at the PSI hearings is the "touting" of CFTC registration as evidence of legitimacy. Advertisements for commodity futures trading firms frequently note registration with the CFTC, creating an illusion of the respectability and integrity of the firm. Confirmation by the CFTC that the firms and agents are in fact registered further complicates the matter by reinforcing the belief that the firms are responsible.

As noted by Edward Dangel, the court-appointed receiver for the CP/Bartex Petroleum case:

There is no early warning system here. Because of the cloaks of respectability that operators have at their disposal, because of the way these operations are set up, there is really an unsuspecting public. In fact, one of the good things about these hearings is: If there is widespread knowledge of what is being talked about here, the public may simply hang up the phone when the scam operator calls. They shouldn't buy commodity futures contracts over the telephone. Right now the public isn't aware and the public very often doesn't call either the CFTC or the State agency when they are called.

And when they do, there is a lead time which makes it difficult for the State agencies and the CFTC to know exactly what is going on and how to respond.

Furthermore, these companies take a good name. I think in the testimony we have just heard, we heard the names Jefferson and Lincoln. In the companies I am involved in, you have Ramco Petroleum, you have Bartex Petroleum. They sound pretty good.⁸⁴

Individuals who seek verification of the legitimacy of commodities firms often encounter additional problems.

Several victim witnesses appearing before the Subcommittee described their efforts to secure consumer information regarding the

⁸³ Letter from E. C. Mackey, Director of the Corporation and Securities Bureau, Michigan Department of Commerce, to Senator William V. Roth, Jr., January 26, 1982. (Hearings, Exhibit 9).

⁸⁴ Hearings, p. 86.

firms prior to making commodity investments. Barbara Hess, who invested approximately \$45,000 with Federal Gold and Silver in Minneapolis, Minnesota, contacted the CFTC before investing. She stated:

When I asked specifically about Federal Gold and Silver, I was told that they, indeed, were registered with CFTC and that the firm was in good standing with them. And that statement from the CFTC representative was really the spur that gave me the confidence to deal with Federal Gold and Silver. I thought it was a legitimate firm. I was totally naive assuming that the government agency—that it meant something.⁸⁵

Similarly, Curtis L. Washington, a Milwaukee probation officer, who invested approximately \$5,000 with the Republic Advisory Corporation, called the CFTC before investing.⁸⁶ Finding that both the firm and the salesman were registered, he agreed to do business.⁸⁷

Another victim, Richard J. MacMillan, from Hudson, New Hampshire, contacted the CFTC regarding the International Trading Group, "under the impression that (registration) meant the firms were bona fide."⁸⁸ Mr. MacMillan eventually lost some \$1,750.

These statements prompted serious questions from Subcommittee Chairman Roth to CFTC Chairman Philip M. Johnson at the Subcommittee hearings:

Chairman ROTH. Mr. Chairman, on the first day of the hearings, we had a lady before us who testified that she lost her life savings and she said that before she got involved with this particular operator, she called your Commission to find out whether or not they were registered. She was advised, yes, that they were registered and in good standing.

Now, to the typical small investor, I think that would be very significant. I notice that in a number of ads in the Wall Street Journal of today, you have companies—this one is First National Monetary Corporation. It has down there, "Registered commodity trading advisor, CFTC." There is another one in yesterday's paper, Wall Street Journal, Premex, "Registered Commodity Futures Trading Commission."

Why do you allow companies to tout registration when it really means very little and, in many cases, can mislead innocent investors?

Mr. JOHNSON. The granting of a registration at the Commission is not intended to be an endorsement. I appreciate that it is frequently perceived in that fashion.

Chairman ROTH. What should you do about it since that is a fact?

Mr. JOHNSON. Well, we have a regulation, as I referred earlier, that prohibits people from misusing that. We do not

⁸⁵ Hearings, p. 10.

⁸⁶ Hearings, p. 95.

⁸⁷ During testimony before the Subcommittee, CFTC Chairman Johnson noted that the Commission had previously maintained a WATS line for investor inquiries. The line "was discontinued by Commissioner Stone when he was Chairman because there was a tendency to leave the public with the impression that an answer yes to the question would, in fact, infer an endorsement on our part." Thus, at the present time there is no direct consumer-investor access to CFTC registration information and, for investors who act upon their own initiative to verify a firm or agent's credentials, registration itself has little meaning.

See Hearings, p. 122.

⁸⁸ Hearings, p. 96.

at this time preclude people from identifying the fact that they are registered. I believe firms in the securities business frequently do the very same thing in relation to their registration at the SEC.

Chairman ROTH. Is that registration investigation the same type as yours or is it more exhaustive?

Mr. JOHNSON. We have tried to follow the very pattern the SEC does in our registration procedures, with the exception of the fingerprinting requirement which will take effect this summer. Excuse me, Mr. Chairman. We run the names through the SEC in our own registration procedure.

Chairman ROTH. I am not persuaded running it through the various agencies means that much. I think the fact, particularly to the small investor, and that what we are concerned about—you have two problems, and I agree much with what you say, as the industry itself is concerned. Most of them are honest, law abiding and trying to do the right thing, but you have the other side of the coin and that is, your responsibility as well under the law.

It does bother me very much that the innocent person, and you can say let the buyer beware but I think that day is long past, you have this advertisement in the Wall Street Journal which says it is registered with you. It does make a lot of people feel it is a responsible firm. I think this has to be dealt with. I am not sure what he answer at the moment is. I am not satisfied that the Commission is discharging its responsibility to the consumer.⁶⁹

ENFORCEMENT OF THE CEA

In light of the questionable ability of the CFTC to screen unqualified and undesirable elements from commodity trading, the Subcommittee probed into the ability of the CFTC to discover and combat off-exchange commodity fraud. The Commission's Division of Enforcement, charged with this responsibility, is authorized to investigate and prosecute alleged violations of the Commodity Exchange Act or Commission regulations. The Division is composed of two units: (1) Market Integrity, which regulates transactions carried out on those contract markets approved by the Commission, and (2) Customer Protection which concentrates on halting the sale of unlawful commodity options not traded on CFTC approved exchange, including illegal commodity options, authorized leverage contracts and other fraudulent operations.

Although responsible for off-exchange enforcement, the Customer Protection Unit is composed of only 23 attorneys, 9 investigators and 11 secretaries, manning offices in Washington, New York, Chicago and San Francisco. While highly competent, the Customer Protection Unit appears to be hopelessly outnumbered by commodity fraud operators. Single boiler rooms may employ 50 or more salesmen—several times the total of investigators employed by the CFTC Enforcement Division nationwide.

⁶⁹ Hearings, pp. 135-136.

Another serious problem which plagues the Commission in general and the Enforcement Division in particular is a very high rate of employee turnover. The Commission overall has averaged a 22 percent employee turnover rate in the past four years. One out of every five employees are leaving the CFTC each year! The turnover rate of the Enforcement Division is even worse. In the past three years, its rate was over 30 percent. One out of every three Enforcement Division employees leaves the Commission each year.⁹⁰ In a field as specialized as commodity futures contract trading, a great deal of experience and practical cognizance is necessary to adequately regulate. Where there is a sizable portion of the staff leaving annually, the experience and effectiveness of the Division is bound to suffer.

Despite these odds, the Enforcement Division has met with success in many areas. In the past fiscal year alone, the amount of civil penalties imposed has increased (up 701 percent), the numbers of persons permanently enjoined rose (up 110 percent), more cease and desist orders were issued (up 188 percent), and more customer money was recovered by court-appointed equity receivers (up 352 percent).⁹¹

At the same time, however, the number of public administrative proceedings initiated has dropped and the number of investigations opened has decreased from 777 in FY 1980 to 88 in FY 1981.⁹² Apparently, the Division has decided to commit its limited resources to those larger cases where success is more likely to be achieved. However, the Subcommittee has heard criticism from other law enforcement officials that the CFTC is overly cautious and will only go after the "sure thing".⁹³ But, the Enforcement Division's effectiveness against even large operations cannot always be assumed. For example, in light of the recent rush of schemes involving coal, the Division has chosen to focus on the National Coal Exchange, a monolith involving 16 different "exchanges" and 95 corporations in several states. Intended to be the CFTC coal case, proceedings against the National Coal Exchange have dragged on and some states have felt forced to institute their own anti-fraud actions.⁹⁴ The Subcommittee is concerned about the consequences of a possible CFTC policy which has at its heart a commitment to bring suit only in the case of one coal fraud or one strategic metals fraud. What happens to the other frauds? Who is to fill the void in the current environment of federal preemption?

⁹⁰ Letter from Chairman Philip M. Johnson, Commodities Futures Trading Commission, to Senator William V. Roth, Jr., April 15, 1982.

⁹¹ Letter from Chairman Philip M. Johnson, Commodity Futures Trading Commission, to Senator William V. Roth, Jr., February 17, 1982.

⁹² Id. It should be noted that this decrease is attributable to a reclassification in April of 1980 of what constitutes an investigation.

⁹³ Perhaps one cause of the Enforcement Division's problems is the administrative labyrinth which must be followed in order for any action to be taken. All investigations, nationwide, must first be authorized by the Washington, D.C. headquarters. Once authorized, the investigation may then be undertaken. Following every investigation, a recommendation of action or inaction must be acted upon at several levels in headquarters. The Division must then decide what, if any, action should be taken. Once this decision is made, a memorandum and proposed complaint is circulated throughout the Enforcement Division and any other interested division of the CFTC. After this review, the complaint and the memorandum are sent to the General Counsel for more review. Finally, the Commissioners consider any proposed action.

⁹⁴ In the mid-1970's, the production of domestic coal increased as a means of achieving independence from imported energy fuels. By 1976, state and local law enforcement agencies throughout the Appalachian region had uncovered a complex organization of criminal activity apparently intent upon taking over the coal production companies and their assets. In an effort to monitor the activity, the agencies shared information and cooperated on investigations. This cooperation led to the creation, in 1978, of the Leviticus Project, a multistate task force investigating a variety of white collar crimes affecting industry. See Letter from Steven L. Bashaer, Attorney General of the State of Kentucky, to Senator William V. Roth, Jr., January 29, 1982 (Hearings, Exhibit 9). Also see *supra*, footnote 49.

REMEDIES AVAILABLE UNDER THE CEA

After scrutinizing the ability of the CFTC to screen commodity fraud operators and to enforce the CEA and its regulations, the Subcommittee examined the available remedies under the CEA and the action taken by the CFTC when it is alleged that a person is the victim of fraud. These remedies consist of arbitration and reparations. The arbitration requirements set forth by the CEA⁹⁵ apply only to on-exchange trading, however, and for this reason were not fully examined by the Subcommittee in its review.⁹⁶ The reparations procedures outlined in the Act⁹⁷ are available for both on-exchange and off-exchange trading and related directly to the Subcommittee's review of off-exchange commodity fraud.

The "reparations" process, authorized under Section 14 of the Commodity Exchange Act, provides that any person may institute an administrative proceeding against persons registered under the Commodity Exchange Act for a violation of the Act or any of the Commission sponsored rules or regulations promulgated thereunder. The Commission has interpreted the language of Section 14 to extend to persons who should have registered under the Act as well as to those who have in fact registered. This is an important holding since, at least prior to 1981, commodity fraud artists made little effort to be registered with the Commission.

A reparations action is instituted by filing a complaint with the CFTC's Complaints Section, which is currently under the administrative supervision of the Commission's Executive Director. The Complaints Section is designed to serve as a clearinghouse for customer complaints and supposedly investigates to determine whether complaints should be processed further.

Our review of the Complaints Section indicated a serious problem of understaffing. Perhaps because the section is being reorganized, PSI investigators encountered enormous problems in locating files. Many were incomplete, missing or, according to the CFTC, simply "unavailable". An initial review by Subcommittee staff found 1,200 cases unaccounted for. After various sets of files were located over a period of two weeks, the number of missing cases shrank to a "mere" 100. In the Reparations Unit, files are scattered throughout a number of different systems. A customer's file may be in one of several different file systems, in the Administrative Law Judge's files, in a clerk's file, in transit from one to another, or packed away in one of the countless cardboard boxes that are stacked from floor to ceiling throughout the Unit. Attempts to retrieve and examine files proved to be equally futile. Rarely were Subcommittee investigators able to obtain all of the basic information which they requested.

THE REPARATIONS PROCESS

The first step for the defrauded customer is to have his complaint accepted by the CFTC. In past years the initial review of complaints

⁹⁵ Commodity Exchange Act, *supra*, footnote 14 (current version at 7 U.S.C. § 5a(11) (1976)).

⁹⁶ For a further discussion of arbitration see Nastro, *Remedies and Redress in Commodity Disputes: Recourse in the Courts*, 35 A.B.A. Bus. Law. 765 (1980).

⁹⁷ Commodity Exchange Act, *supra*, footnote 14 (current version at 7 U.S.C. § 14 (1976)).

was sometimes handled by clerical personnel who decided whether the complaint stated a cause of action. Thus, they decided the fate of the complaint. For example, during FY 1980 the Complaints Section received 1,401 claims, but forwarded only 721 (51 percent) to the Hearings Section for further action. For some 680 complainants, a judicial determination was made in their case by clerical personnel.

But there are other reasons for being turned away. For example, in 1981 Eugene Manley of Montana complained to the New York Attorney General about Mineral Resources, Inc., a Manhattan company (since indicted) from which he had recently bought \$1,700 worth of tantillum, a "strategic" metal. New York sent him to the CFTC where he was told "the CFTC does not handle strategic metals," although he had been told by the Commission before purchasing that the firm was registered with the CFTC. Much to his amazement, he was denied reparations on the grounds that Mineral Resources, Inc. was not under CFTC jurisdiction. This is especially baffling in so much as the CFTC has since sued a large strategic metals firm in Florida. (See *CFTC v. Prime Strategic Metals*, Civ. No. 81-6615 (S.D. Fla. 1981)).

REPARATION DELAYS

Once the Complaints Section determines that a valid cause of action has been stated, the complaint is forwarded to the respondent for an answer. The case is simultaneously forwarded to the Hearings Section for assignment to an administrative law judge (ALJ).⁹⁸ Thereafter, numerous rules and regulations of the Commission relating to reparations proceedings are triggered and the victimized customer enters the never, never land of reparations litigation. Although it was designed by Congress to be an easy, quick, and efficient method of resolving customer claims, the reparations process has developed into a veritable nightmare for the defrauded customer.⁹⁹ In a recent review of the CFTC, the GAO discovered that processing a reparations claim may take an average of three years to complete and may result in commodity attorneys fees amounting to as much as \$10,000.¹⁰⁰ The customer faces any of a series of obstacles in his effort to actually recover money after the filing of his claim. In 1978, the GAO found that the reparations program was neglected by the Commission, in that only minimal resources were devoted to this area and no uniform standards were established for use by the Administrative Law Judges. The CFTC, in its "Response to the Report of the Comptroller General" of July 14, 1978, promised changes in these areas. No such changes have ever been implemented. In the words of the Director of CFTC's Complaints Section, "there are currently inordinate delays in the operation of the total reparations system of the Commission."¹⁰¹ Indeed, as indicated below, our study has confirmed the director's statement.

Theoretically, the Reparations Unit should provide a standardized procedure for the adjudication of claims. The ALJs and the Hearing Officer are supposed to operate pursuant to uniform procedures estab-

⁹⁸ Claims amounting to less than \$5,000 are handled by a hearing officer of limited jurisdiction. The CFTC currently employs only one officer in this capacity.

⁹⁹ Subcommittee investigators discovered that complainants may even have difficulty in filling out the necessary forms to file a reparations claim. Victim Barbara Hess testified that complainants "obviously need an attorney" to complete the required claim. See *Hearings*, p. 10.

¹⁰⁰ *Hearings*, p. 106.

¹⁰¹ *Commodities Law Letter*, Vol. No. 3 (May, 1981).

lished by the Commission. Instead, the system is subject to differing interpretations which often result in conflicting opinions in similar cases.

For example, currently in the Reparations Unit, the standards of service of process used by the ALJ's are radically different from those of the Hearing Officer. If a firm has moved or gone out of business, the ALJs will rule that service has been properly made if mailed to the address which the company put forth on its most recent registration statement. Hearing Officer Robert Joost, however, has ruled that the complainant, the person alleging fraud, must provide a present address where the company or its principals are currently located. If the firm has gone out of business, it is up to the complainant to conduct his own investigation and find the principals, a task that the Enforcement Division itself is often unable to do.

In the case of the Republic Advisory Corporation, against which the CFTC obtained a court injunction for fraud, there have been numerous occasions when the ALJs have ruled that service of process, mailed to Republic's registered address and returned unanswered, has been valid and default judgments have been entered for the complainants. In regard to the same Republic Advisory Corporation, Hearing Officer Joost has held that mailings to the registered address which were returned unanswered were not valid service and has dismissed the complaints for lack of jurisdiction!

Curtis Washington of Milwaukee, Wisconsin, is just one of the individuals who has been denied relief by Hearing Officer Joost's decisions. Mr. Washington lost \$5,000 to Republic Advisory, and attempted to obtain relief through the CFTC Reparations Unit. The CFTC informed Mr. Washington that he would obtain a default judgment if Republic Advisory did not answer the complaint. Three months later, Washington received another letter stating that the CFTC could not locate Republic Advisory, could not make service, had no jurisdiction and thus was dismissing Mr. Washington's claim.¹⁰²

When the Chairman of the CFTC was questioned regarding this action, Mr. Johnson apologized for sending the first letter.¹⁰³ Chairman Johnson offered no explanation as to why the judges did not have standard operating procedures, why the Commission continued to allow totally contrary decisions to stand, or why a victim should be required to obtain a current address of a bandit operation, when the CFTC itself is unable to obtain it.¹⁰⁴

The Commission has failed to overturn either procedure and has in effect turned this judicial forum into a crap shoot. If the victim of a defunct commodity scam is lucky enough to be assigned to an ALJ, he may obtain a default. If the Hearing Officer gets his case, it will be thrown out.

¹⁰² Hearings, p. 95.

¹⁰³ Hearings, p. 134.

¹⁰⁴ In a similar case, Dave Schonbach of Wilmington, Delaware, filed a reparations claim with the CFTC against Connors and Davenport, Ltd. The complaint was acknowledged by the CFTC on November 30, 1979, noting that the firm was not registered with the CFTC, that the firm appeared to no longer be in business, that attempts to serve the complaint on the firm had been unsuccessful, and that "until an address is obtained, we will not attempt to serve your complaint on Connors and Davenport, Ltd." Several months later, Mr. Schonbach contacted the CFTC in an attempt to learn the status of his complaint. The CFTC replied by letter dated February 11, 1980, again stating that the firm was no longer in business, that attempts to serve the complaint had been unsuccessful, and that "unless you provide this unit within 30 days with an address at which Connors and Davenport can be successfully served, we will take no further action on this matter and the file will be closed." See Hearings, p. 19. Also see Hearings, Exhibit 1.

Delays in the reparation process can occur at any of several stops along the way. First, there can be a delay in the forwarding of the complaint from the Complaints Section to the Hearings Section. Secondly, after the complaint has been received by the chief administrative law judge, it may take weeks or even months for the judge to assign the case to one of his fellow administrative law judges, apparently on the assumption that the other administrative law judges already have a backlog of cases and further assignment would serve no useful purpose. Once the respondent is served with the complaint, theoretically, he has 45 days to answer and any failure to do so is deemed to be an admission of guilt. That is, after 45 days, the respondent is entitled to a default judgment. PSI investigators learned that default judgments are seldom granted after 45 days and, indeed, the respondent may wait for months or even years before being granted a default judgment. The hearing record is replete with examples.

Once the case actually comes under the consideration of an ALJ the person may work fairly rapidly. However, productivity levels vary greatly among the various ALJ's¹⁰⁰ and delays between the close of evidence and initial decision are sometimes lengthy. After an initial decision has been rendered, the next step in the process involves a review of the ALJ's decision by the Commission. Either party may petition the Commission for a review, and experience has shown that such petitions are commonplace. Since the losing party can invest whatever funds he may be required to pay to the winning party at money market rates, and the Commission may charge only 12 percent interest during any interim review period, it is obviously in the best interest of the respondent to seek review. Our study has shown that the Commission may take months to decide the case at this level and the party at fault may use this time to his financial benefit.

AVERAGE NUMBER OF DAYS REQUIRED TO PROCESS CASES¹⁰⁰

Average number of days from—	1976	1977	1987	1979	1980	1981
Filing to docketing.....	67	100	247	194	135	119
Docketing to assignment to an ALJ.....	42	70	160	373	289	100
Assignment to ALJ to adjudication.....	422	366	438	222	76	63
Notice of appeal to decision by CFTC to grant or deny the appeal..	410	294	158	(x)	(x)	(x)
Granting of appeal to CFTC final decision.....	788	343	126	(x)	(x)	(x)

(x) There have not been enough cases disposed of in these categories to develop accurate statistics.

¹⁰⁰ (1) "Operational Review of the Office of Hearings and Appeals," James South, June 24, 1977; (2) Report to the House Committee on Appropriations ("Whitten Report"), 95th Congress, 2d session (1978); (3) "Regulation of the Commodity Futures Markets—What Needs to Be Done" ("GAO Report"), Government Accounting Office, May 17, 1978; (4) "Operational Review of the Division of Enforcement's Reparations Units," John Field III, Nov. 27, 1978; (5) "Reparations Improvement," Robert Joost, Oct. 30, 1979; and (6) Government Accounting Office Audit of 1982. See Hearings on S. 2109 Before the Senate Committee on Agriculture, Nutrition and Forestry, 97th Congress, 2d session (1982) (Testimony of Clinton Burr).

As an indication of the success of the system, Subcommittee investigators attempted to discover how many awards actually resulted in collection. Investigators randomly selected default judgments resulting in awards between October 1, 1980 and January 31, 1981. During that period, 20 default judgments resulted in awards. Of these 20 cases, only 8 files could be located at the Reparations Unit. The Director of the Complaints Section told Subcommittee investigators that he was too

¹⁰⁰ At one point, Subcommittee staff discovered a case in which an order should have been issued over two years ago. When questioned why the ALJ had not yet entered an order, a CFTC hearing worker replied, "He's out of town a lot."

busy to look for the remaining case files and that the files probably would not be found. Using these 8 cases, the investigators were able to contact 5 of the parties to whom awards had been granted. None of the parties contacted had ever received any payment on their award. Consider two of the five:

(1) "The CFTC took so long in awarding the money, that we lost track of the broker and never could find him again to collect it." (Mrs. Fredrick G. Dempsey, Case No. R78-602-79-535.)

(2) "I had a couple of lawyers looking into it, but nothing has been done. It's not worth any more lawyers fees to collect \$2,500." (Anthony DelGreco, Case No. R78-135-79-143.)

In response to this problem, the CFTC has chosen a rather strange course of action. The Commission has *not* decided to implement bonding requirements, stricter registration or other regulations. Rather, the CFTC has decided to address the ineffectiveness of the reparations process by allowing only those claims that are likely to be successful. The Commission is, in the words of Chairman Johnson, "proposing to narrow the program somewhat so as to eliminate those classes of cases with the highest rate of worthless and uncollectable awards."¹⁰⁷

Additional problems arise when the subject of a complaint is known by the reparations staff to be in bankruptcy or receivership. In these cases, the complaint will be either rejected by the CFTC Complaints Section or put on "hold" in the Hearings Section. Under the CEA, reparations claims are automatically stayed upon a filing of bankruptcy by the respondent. Since commodity thieves are continually going broke or being sued, it is not uncommon for the reparations cases of defrauded customers to stack up like cord wood at the CFTC. Where the company has been looted or the funds have been diverted outside of the company, reparations proceedings are almost totally ineffective remedies, according to Barrington Parker, the receiver of Fairchild, Arabatzis and Smith.¹⁰⁸ Since there is no money to recover, there is no need to proceed on the cases. Here are some examples:

CFTC case number	Date filed	Amount of claim	Date stayed
R77-217	April 1977	\$2,500	March 1978.
R47-304	May 1977	4,302	Do.
R77-335	do	4,209	Do.
R77-360	do	4,780	Do.
R79-276	December 1978	14,262	September 1980.

LEVERAGE COMPLAINTS

Without doubt, the greatest number of complaints by category of entity charged have been lodged against so-called "leverage firms." These firms enjoy a special relationship by statute (Section 19 of the

¹⁰⁷ Hearings, p. 120.

¹⁰⁸ Letter from Barrington Parker, receiver of Fairchild, Arabatzis and Smith, to Senator William V. Roth, Jr., November 17, 1981 (Hearings, Exhibit 10).

Commodity Exchange Act) based upon the unusual instrument they market. As discussed later, it is clear that there is virtually no state or federal regulation of these firms today.¹⁰⁹

Statistics compiled by the CFTC indicate the following number of complaints lodged in the hearings section against leverage firms, from the beginning of reparations until December 1981, with their overall "ranking":

Bank:	Complaints
(1) First Commodity Corp. of Boston (non-member FCM)-----	130
(2) Rosenthal & Co. (member FCM)-----	97
(6) Monex (leverage firm)-----	64
(10) Premex (leverage firm)-----	44
(11) International Precious Metals Corp. (leverage firm)-----	42
(12) First National Monetary Corp. (leverage firm)-----	38

It also appears that leverage contracts tend to involve a larger amount of money than other such contracts. Subcommittee investigators used Reparations United figures from April 21, 1980 to November 23, 1981, the available period in which complaints were so categorized, to develop the following statistics:

Type of instrument	Number of claims	Total amount	Total percent of all complaints	Total percent average of dollars claimed	Claims
Off exchange instrument.....	294	\$6,183,944.95	14	7.86	\$21,033.99
Leverage.....	289	29,723,234.67	14	37.76	102,848.56
Futures.....	1,289	42,423,923.57	70	53.89	32,912.27
Pools*.....	49	387,261.90	2	49	7,903.30
Total.....	1,921	78,718,415.09	100	100	

*Figures for pools were available only from Oct. 20, 1980 to Nov. 21, 1981.

The average leverage complaint in this limited examination is three times larger than the average futures complaint, more than ten times larger than commodity pool¹¹⁰ complaints, and almost five times larger than complaints involving off-exchange instruments.

OVERALL REPARATIONS STATISTICS, INCLUDING RECOVERIES

The Staff's analysis of reparations statistics required the work of two investigators for approximately three weeks since many statistics of interest are unavailable at the CFTC. The investigators counted each file and continually sought documentation of existing CFTC statistics from Commission personnel. Ultimately our inquiry showed as follows:

¹⁰⁹ See pp. 56-59 of this Report. Also see Smith, *supra*, footnote 24.

¹¹⁰ Pools are generally defined as "a combination of persons or corporations engaged in the same business, or for the purpose of engaging in a particular business or commercial or speculative venture, where all contribute to a common fund, or place their holdings of a given stock (in this case, commodity) . . . in the hands and control of a managing member or committee . . . with a view to the successful conduct of an enterprise too great for the capital of any member individually, and on an agreement for the division of profits or losses among the members, either equally or pro rata." Black's Law Dictionary 1321 (4th Ed. 1968).

REPARATIONS CASES ARISING, FISCAL YEARS 1978-81

	Cases	Amount claimed
Complaints section:		
Received from complainants.....	4,594	\$125,528,470.92
Still open.....	441	29,277,531.56
Balance.....	4,153	96,250,939.36
Disposition:		
Dismissed.....	1,034	\$16,249,467.78
Settled.....	246 1,280	1,633,790.18 17,883,257.96
Total.....	2,873	78,367,681.40
Hearings section:		
Received from complaints section.....	2,873	78,367,681.40
Open cases:		
Assigned to ALJ.....	1,093	27,544,518.65
Default.....	153	5,407,273.00
Awaiting filing fees.....	320	6,075,235.62
Fees paid, not assigned.....	193 1,759	7,401,538.44 46,428,565.71
Balance.....	1,114	31,939,115.69
Closed cases:		
Dismissed.....	212	2,242,083.14
Settled.....	344	4,371,542.15
Defaults.....	242	5,913,144.00
Other decisions.....	213 1,011	2,596,543.71 15,123,313.00
Cases unaccounted for.....	*103	
Value of cases with no disposition.....		16,815,802.69

*The staff was advised that it is not uncommon to have 100 claims unaccounted for. They are usually floating between the complaints and the hearings section.

REPARATIONS CASES CLOSED BY THE HEARINGS SECTION, FISCAL YEARS 1978-81

	Number of cases	Value of claims
Disposition:		
Settled.....	344	\$4,371,542.15
Decisions.....	213	2,596,543.71
Dismissed.....	212	2,242,083.14
Defaults.....	242	5,913,144.00
Total.....	1,011	15,123,313.00
		Estimated value of settlement* or actual amount of judgment
	Number	
Cases resulting in customer awards:		
Settled cases:		
(1) In complaints section.....	246	\$1,143,653.13
(2) In hearings section.....	344	1,967,193.97
Default cases.....	242	5,913,144.00
Litigated cases.....	213	2,596,543.71
Total.....	1,045	11,620,534.81
Actual recoveries by customers after settlement or judgment:		
Settled cases.....	† (590)	3,110,847.10
Litigated cases.....	(47)	226,813.85
Default cases.....	‡ (24)	295,657.00
Total.....		3,633,317.95

*According to CFTC, average settlement at complaint stage equals 70 percent of claims and at hearings stage equals 45 percent of claim.

† Estimated.

‡ The staff estimates that perhaps 5 percent of default judgments are actually collected. The CFTC has no figures and does not offer estimates of actual default recoveries. The staff's random sampling failed to disclose anyone who had actually recovered on a default.

Note: Thus, we estimate only \$3.6 million of the \$125.5 million in claims was actually recovered in reparations during this period. This represents 2.9 percent of total claims.

CAUSES OF COMMODITY FRAUD GROWTH

There has been considerable debate in recent years regarding the effectiveness of the regulation of commodity futures trading. The Subcommittee, in its investigation, confirmed the existence of serious problems in the area of commodity futures regulation and the role of the CFTC in that regulation.

The CFTC, pursuant to Section 2(a) of the Commodity Exchange Act (CEA), has been granted exclusive jurisdiction over the regulation of commodity futures trading. With an expected annual budget of approximately \$20 million in 1982, the CFTC will employ about 470 persons in the Washington, D.C. headquarters and five regional offices nationwide. The regulatory jurisdiction of the CFTC currently extends to the trading of 107 types of futures contracts on 11 organized exchanges. More than 50,000 persons are registered with the CFTC as Future Commission Merchants, Floor Brokers, Commodity Trading Advisors, Commodity Pool Operators and Associated Persons. The Commission is also empowered to regulate an unknown number of off-exchange instruments, some of which are traded legally and some of which are inherently fraudulent and traded in violation of the current regulatory scheme.

The inability of the CFTC, with its extremely limited resources, to effectively regulate the vast universe of commodity trading is now well established. The Commission itself admits as much; as Chairman Johnson stated during the Subcommittee's hearings, "It has been said that the Commission does not have the resources to stop all of the off-exchange frauds. This is not only true, it is obvious."¹¹¹ The Enforcement Division, composed of fewer than 100 persons nationwide, is expected to investigate and prosecute all alleged violations of the Commodity Exchange Act and Commission regulations involving the trading of commodity futures contracts on domestic exchanges and the off-exchange trading of commodity instruments. The Registration Unit, required to process all initial and renewal registrations and conduct fitness investigations of the more than 50,000 registered persons, has only 17 employees. The CFTC is seriously understaffed to carry out the duties mandated to it by the current regulatory scheme.

Such an insurmountable workload further hinders regulatory efficiency by its effect on morale. Even assuming that all of the Commission's staff are highly competent and extremely diligent, the amount and complexity of the work fosters frustration and discontent.

As previously noted, there is a very large turnover rate of Commission employees. On the average, every year one out of five employees leaves the Commission and one out of every three employees leaves the Division of Enforcement. While the staff of the CFTC appears to be sufficiently competent, the simple logistics of the problem render effective regulation a truly herculean task. This was illustrated in the hearings by Edward Dangel, a court-appointed receiver, during questioning by Senator Sam Nunn.

Senator NUNN. Is the primary problem competency of people involved at the CFTC or is it one of numbers?

¹¹¹ Hearings, p. 118.

Mr. DANGEL. I think it is one of numbers, Senator. I think there is simply not enough staff, there just are not enough lawyers to handle this widespread off-exchange fraud. I think once the CFTC gets involved, given the difficulties inherent in prosecuting these schemes—they are very complicated and difficult for judges and juries to understand—once they are involved, they do a pretty good job of it. But I think that the States need to be considered the early warning system and be very, very active, in fact, be the essential ingredient in these prosecutions because they seem to be able to get a little bit quicker than CFTC has been able to act.

FEDERAL PREEMPTION

The statutory framework of the Commodity Exchange Act itself hinders the effective regulation of futures trading. Perhaps the greatest hinderance to effective regulation in the Act is the preemption of state regulation of commodity futures trading. Unlike securities, for which the 1933 and 1934 Securities Acts permit concurrent state jurisdiction, the states are precluded from enacting any laws relating to the regulation of commodity futures trading. The states, under their Blue Sky Laws, may regulate the means by which securities are offered and traded, and require persons engaged in the sale of securities to register with the state in which that business is conducted. The Commodity Exchange Act specifically prohibits such jurisdiction to the states in regard to commodities.

As noted by Richard Latham, the Texas State Securities Commissioner, in his statement to the Subcommittee:

(T)he effect of federal preemption has been to fire the cops in the midst of the crime wave. As to off-exchange transactions, the need for uniformity of regulation is overshadowed by the need for an effective criminal justice system. With all due respect to the federal court system, most criminal cases in white collar crime as well as elsewhere have always fallen to state prosecutors. By denying state enforcement officials the jurisdictional tools to do their jobs, the public and the public's confidence in commodity investments have been damaged. The preemptive language currently contained in the Commodity Exchange Act has created a law enforcement disaster area in off-exchange commodity fraud, which must be corrected by legislative action.¹¹²

To be more specific, federal preemption prevents the states from implementing two proven means of combating investment fraud: the use of state administrative orders and the use of the state administrative subpoena power.¹¹³ Although the states are allowed to bring joint state-CFTC actions in federal district court, states have found such actions to be feasible only "when the targets are present in the state concerned."¹¹⁴ This creates particular problems for states where victims, rather than violators, are found.

¹¹² See Malmgren, *supra*, footnote 79. Also see, letter from David Hart Wunder, Commissioner of Securities, Office of the Secretary of State, Illinois, to Senator William V. Roth, Jr. January 13, 1982 (Hearings, Exhibit 9).

¹¹³ See Malmgren, *supra*, footnote 79.

¹¹⁴ Hearings (Statement of Richard Latham).

Under present federal commodity regulations, the states are permitted to bring an action pursuant to the CEA only in a federal court. Although touted by opponents of expanded state jurisdiction as providing sufficient state powers, such actions are rarely taken. State officials operate under the restrictions of state law and often do not have the authority under their state constitutions to appear in federal court. This authority must then be given by an act of the state legislature, a time consuming process that does not facilitate swift enforcement. Once given the authority to proceed in federal court, the state enforcement agency must overcome the ever present reluctance of state officials to spend state money to enforce federal law. As noted by Alabama Securities Commissioner Thomas L. Krebs, "The Alabama Securities Commission and the Attorney General's office are funded by our legislature to enforce state law, not federal law."¹¹⁵ This sentiment was enthusiastically echoed by Attorney General Robert Abrams of New York,¹¹⁶ and Commissioner Latham of Texas.¹¹⁷

The Subcommittee also found that state officials, experienced in state law and procedure, may prove to be ill-equipped to effectively proceed in federal courts.¹¹⁸ Thus, state officials must circumvent the natural inclinations of their superiors in order to proceed in an unfamiliar forum to enforce a federal law, which is itself a morass of confusing draftsmanship.

As a result of these factors, state agencies are saying "let the federal authorities handle the federal problem." But, the already overworked CFTC is not able to respond and the citizens of those states are not adequately protected.

On other occasions where joint state and CFTC actions are taken, many of the states have voiced additional frustrations. For instance, Commissioner Mary Ann Brophy of the Minnesota Commission of Securities and Real Estate has told the Subcommittee:

Minnesota initiated a case under Section 6d of the Commodity Exchange Act against Federal Gold and Silver in 1979. Although this was a successful case resulting in criminal convictions for each of the defendants, it was one which occupied four entire months' work on the part of four investigators (half of this agency's enforcement staff). Policy questions, unfamiliarity with the federal laws, and filings of notice with the CFTC were several of the burdensome and time-consuming aspects of the investigation and prosecution. We are clearly unable to divert such a large percentage of our resources to such projects at the expense of our other responsibilities. *More significantly, had Minnesota not been preempted from jurisdiction over Federal Gold and Silver, we*

¹¹⁵ Letter from Thomas L. Krebs, Director of Alabama Securities Commission to Senator William V. Roth, Jr., February 19, 1982 (Hearings, Exhibit 9).

¹¹⁶ Letter from Robert Abrams, New York Attorney General to Senator William V. Roth, Jr., June 30, 1981 (Hearings, Exhibit 9).

¹¹⁷ Letter from Richard D. Latham, Commissioner, Texas State Securities Board, to S. Cass Welland, Chief Counsel to the Permanent Subcommittee on Investigations, October 7, 1981 (Hearings, Exhibit 9).

¹¹⁸ "As a practical matter, I do not personally believe that state actions brought pursuant to provisions under the Commodity Futures Trading Commission Act are a viable solution to the problems as voiced by the CFTC. The difficulty of developing expertise in a new statute alone insures its impracticability. The proposition that a state agency should attempt to enforce a federal statute seems wholly inappropriate." Letter from James F. Whitescarver, Jr., Director of Securities, District of Columbia, Office of the Public Service Commission, to Senator William V. Roth, Jr., January 12, 1982 (Hearings, Exhibit 9).

*would have required that the firm and its agents obtain licenses. Had we been able to do so, we would have been alerted to the previous violations of certain individuals involved. In addition, we would have required registration of the contracts for deferred delivery under our securities law. We could have moved more quickly to prevent widespread solicitation without registration through the use of our cease and desist powers.*¹¹⁹ (Emphasis added.)

The Maryland Securities Commission experienced similar frustrations in a joint CFTC/State action. In 1979, the Securities Commission agreed to allow the CFTC to join an on-going investigation of the Annapolis Funding Corporation. From that time forward, the action was subject to delays by the CFTC, which Maryland Securities Commissioner Houston Matney characterized as "commission level policy decisions or non-decisions . . . by . . . the chain of command running from Commission level to General Counsel and then to the Enforcement Division."¹²⁰ After more than a year, a consent settlement was obtained in the Federal District Court of Maryland, accompanied by out-of-court administrative settlements with the CFTC and the State. According to Matney, Annapolis Funding was allowed to continue doing business during the year of investigation and subsequent litigation, taking in millions of dollars but the receiver appointed by the district court was able to find only \$12,000 in assets.

Following this action, the Maryland Securities Commission notified the CFTC that, due to the frustrating delays, it would be an inappropriate use of state resources to proceed in future cases by way of joint action.

In 1981, operating without the CFTC and notwithstanding the preemptive provisions of the CEA, the Maryland Securities Commission proceeded under its own state security laws and administratively obtained a cease and desist order against a boiler room operation. The time from the beginning of the investigation until the issuance of the cease and desist order: less than 6 weeks.¹²¹

In correspondence directed to the Chairman of the Subcommittee, the Director of the Alaska Department of Commerce and Economic Development Securities Division, Willis F. Kirkpatrick, discussed the direct impact which federal preemption has had upon that state. He notes:

In 1975, with the advent of the CFTC and the preemption from state enforcement, the commodity con-artists came out of the woodwork and operated virtually unchecked in Alaska until the ban on commodity options in 1979 took effect. The presence of the CFTC in this state is and has been virtually nonexistent in spite of the many schemes perpetrated in Alaska primarily aimed at pipeline workers. It is the general feeling of the staff of the division and other Alaska white collar enforcement agencies that the CFTC as presently com-

¹¹⁹ Letter from Mary Ann Brophy, Minnesota Commissioner of Securities and Real Estate, to Senator William V. Roth, Jr., October 8, 1981 (Hearings, Exhibit 9).

¹²⁰ Hearing, p. 114.

¹²¹ *Id.*

*posed, has acted as an aid rather than a hindrance to commodity fraud activities in this state.*¹²² (Emphasis added.)

Opponents of expanded state jurisdiction also point to Section 6d (7) of the Act, which provides that the states will not be prohibited from proceeding in state court on the basis of alleged violations of anti-fraud statutes of that state. Few such cases have been brought, however, because the unusual nature of commodity fraud schemes tends to render local district attorneys helpless. These are not petty larceny cases of door-to-door scams operated by local concerns. The greater complexities of investment vehicles require the presence of the state authorities most familiar with the problem—securities commissioners. Yet the cons are the first to point out that those affairs are preempted.

However, general anti-fraud statutes usually require that a victim suffer injury, be deprived of some right, be cheated, or suffer damages.¹²³ In a commodity futures fraud, there is no damage or injury until after the time of delivery has passed and no delivery has been made. In most boiler room operations, delivery is intentionally delayed until the company has had an opportunity to bilk numerous investors. Then, immediately before the time of delivery, the company is dissolved and the principals and salesmen disappear. State general anti-fraud laws are inadequate to deal with the complex time-deferring provisions involved in commodity futures frauds inasmuch as they may be unable to prove actual fraud until the schemers have absconded with all of the liquid assets of the company.

States are also severely hampered by Section 8(e) of the CEA, which specifically grants the CFTC authority to disclose information to other federal agencies. No mention is made of sharing information with the states. CFTC General Counsel John Gaine, in a July 6, 1979 memorandum to the CFTC Director of Enforcement, stated that Section 8(e) of the Act precludes the CFTC from sharing any of its investigative information with the states. As a result, the CFTC continually attempts to obtain information from the states but refuses to provide the states with similar information.¹²⁴

The CFTC has also evidenced, in some cases, a jealous protectionism of its exclusive jurisdiction, further frustrating the enforcement efforts of the states. In 1977, the CFTC intervened on behalf of an individual charged with commodity fraud and filed an *amicus curiae* brief challenging Arkansas' efforts to combat commodity fraud.¹²⁵ In at least two other cases, in Tennessee and New York,¹²⁶ the CFTC has opposed the anti-fraud efforts of the states, solely on the basis of infringement of the exclusive jurisdiction of the CFTC.

¹²² Letter from Willis F. Kirkpatrick, Director of Department of Commerce and Economic Development, Division of Banking, Securities, Small Loans and Corporations, to Senator William V. Roth, Jr., October 14, 1981 (Hearings, Exhibit 9).

¹²³ See Black's Law Dictionary, 788-789 (4th Ed. 1968).

¹²⁴ In one instance, a CFTC staff member requested and received the use of several agents and a vehicle from the Securities Division of the State of Florida for a period of several days. The CFTC staff member then asked for and received the use of office space to depose an individual. The agents of the Securities Division who had worked with the CFTC staff member requested to sit in on the deposition but were refused because, as state agents, they were not privy to CFTC investigative information, pursuant to the CFTC's interpretation of Section 8(e) of the CEA. See Memorandum of John G. Gaine, CFTC General Counsel, to John A. Field, III, Director, Division of Enforcement, July 6, 1979.

¹²⁵ Brief for CFTC as *amicus curiae*, *International Trading, Ltd., v. Bell*, 556 S.W. 2d 420 (Ark. 1977).

¹²⁶ See Hearings (Statement of the North American Securities Administrators Association, Inc.).

Such action could be explained if the states were obstructing the concerted national anti-fraud actions of the CFTC. This however, is not the case. Ironically, the CFTC has fought the states to retain a jurisdiction it is unable to effectively regulate.¹²⁷ Chairman Johnson and former Chairman James M. Stone readily admit that the CFTC is incapable of providing complete regulation over the markets and transactions over which it has been provided exclusive jurisdiction,¹²⁸ while the CFTC today fights to retain exclusively in most areas, including commodity pool operations.

Recently Senators Lugar and Helms, on behalf of the CFTC, introduced the CFTC's legislative package (S. 2109) which provides the states with some additional jurisdiction. The states, under this bill, would be able to enact laws applicable to unregistered traders who deal in instruments other than leverage, commodity options and exchange traded futures. The CFTC proposal is purposely limited to retain regulation in the CFTC.¹²⁹

Under the CFTC bill, the state would have to meet certain criteria before obtaining jurisdiction. The state would have to show that the individual was not registered but should have been, and that the subject had in no way dealt in leverage, options or futures traded on an exchange. The CFTC has evidently¹³⁰ that it will attempt to vacate state orders against even the most blatant criminal, to ensure that states do not infringe on the enforcement domain of the CFTC. Such an adversary relationship is hardly conducive to effective enforcement.

The CFTC proposal will not impede a state from going after the blatantly fraudulent charlatan who has no connection with the legitimate commodity industry. The "successful" commodity bandits, however, actively seek to appear to be part of the legitimate commodity industry. This is achieved by registering with the CFTC and trading a few contracts through a legitimate concern to establish an illusion of honest trading. The operation then becomes a hollow fraud. Under the CFTC proposal, mere registration will remove the perpetrators from the police powers of state securities commissioners. The fraud operators, mindful of limited CFTC resources, can thus evade or at least delay, state action.

LEVERAGE

Perhaps the greatest regulatory shortcoming of the CFTC is in the area of leverage transactions. Under the jealously guarded exclu-

¹²⁷ This attitude is especially confounding in light of recent comments by CFTC Chairman Philip M. Johnson, regarding the SEC-CFTC pact on stock options. Responding to questioning concerning the increased responsibilities created by the pilot options program, Chairman Johnson expressed confidence in the enforcement against off-exchange "con artists." See Kim Masters, "SEC-CFTC Pact: Did Either Side Yield Too Much?", *Legal Times*, March 22, 1982.

¹²⁸ See Hearings p. 116; Letter from Chairman Philip M. Johnson, Commodity Futures Trading Commission, to Senator William V. Roth, Jr., June 22, 1981; Letter from Chairman Philip M. Johnson, Commodity Futures Trading Commission, to Representative Benjamin Rosenthal, October 27, 1981; Letter from Commissioner James M. Stone, Commodity Futures Trading Commission, to Senator Richard Lugar, February 23, 1982 (Hearings, Exhibit 19); Letter from Commissioner James M. Stone, Commodity Futures Trading Commission, to Senator William V. Roth, Jr., February 23, 1982.

¹²⁹ Statement by Chairman Philip M. Johnson, Commodity Futures Trading Commission, to the Futures Industry Association. "... our ultimate objectives are ... a credible single (emphasis in original) regulator; and a period of orderly growth not hampered by jurisdictional conflicts ..." March 4, 1982.

¹³⁰ In 1976, the CFTC appeared before the New York Supreme Court in an attempt to vacate an injunction obtained by the State of New York against J. S. Love, which permanently barred him from engaging in either the securities or commodities business in that State. The request of the CFTC was denied. See Hearings, p. 42. Also see *CFTC v. J. S. Love*, Civ. No. 76-928 (S.D.N.Y. 1976).

sive CFTC jurisdiction, leverage has become a multi-billion dollar industry, where no regulations have been implemented and which is limited by a grandfather clause to only four companies.

Section 217 of the Commodity Exchange Act of 1974 provided the CFTC with exclusive jurisdiction over leverage, including the responsibility to promulgate regulations. The CFTC responded with a general anti-fraud rule. In 1976, after a year long study of leverage contracts by the CFTC Advisory Committee on Market Instruments, the Commission directed the staff to prepare leverage regulations. More than one year later, no regulations had been made public. The Commission decided that more study of leverage was necessary. Following reauthorization in 1978, the Commission instituted a "temporary" moratorium on leverage transactions and allowed only firms of a particular financial soundness and age to continue. Only four firms could meet this criteria. These four are currently the only leverage firms allowed by law: International Precious Metals Corporation, Monex International, Ltd., First National Monetary Corporation, and Premex Incorporated.

On July 27, 1979, the CFTC published a notice of the Commission's intention to ban all leverage transactions. Later that year, the Commission voted to postpone the date on which the ban would become effective. On May 28, 1980, the CFTC again postponed the effective date of the ban, but did direct the staff to develop interim regulations, to become effective no later than December of that year. In April of 1981, no regulations had yet been instituted by the CFTC. In fact, a federal judge recently enjoined Commission administrative proceedings against two leverage firms, ruling that the CFTC was attempting to accomplish through litigation what it had failed to do by administrative rulemaking.¹³¹

The Commission, in October 1981, voted to take no action until an additional two year study could be undertaken to examine the leverage industry. At the Subcommittee hearings Chairman Johnson stated that the last study was inadequate because it was only a "photograph," a picture of the leverage industry at one point in time. Chairman Johnson told the Subcommittee that the new members of the Commission must be educated as to all of the intricate nuances of leverage transactions before they will be able to deal with this area.

Mr. JOHNSON. . . . (T)he judgment was that it would be preferable to get an up-to-date and current reading on the leverage business and how it operates rather than to rely upon older studies.

We are concerned that we not take any action, either favorable or unfavorable, until we have a very clear, current picture of their operations.

Chairman ROTH. I can appreciate that there might be certain nuances, changes that you are not familiar with. Isn't it true that by the time you complete the two-year study, you will be gone from the Commission, Commissioner Stone will be gone, Commissioner Gartner will have been replaced?

I find it very difficult to understand why an additional two years is needed when the four firms now in the leverage busi-

¹³¹ *FNMC v. CFTC and Monex v. CFTC*, Civil Nos. 81-7430, 81-74572 (E.D. Mich. Dec. 29, 1981.)

ness will continue, I gather, to enjoy the monopoly they have had for several years.

I also take it that the Commission has no plans to enforce a comprehensive set of regulations, and if it is to take you another two years to do anything, wouldn't it be appropriate to allow the states to regulate these contracts?

Mr. JOHNSON. It is true that at least some of the members of the Commission are not likely to be here when the study is completed, but they will certainly have the full benefit of the study as it progresses.

Chairman ROTH. Why aren't the past studies adequate then? I don't follow.

Mr. JOHNSON. My understanding is the past studies are sort of period pieces, photographs of the nature of the industry at the particular times they were conducted, and that in more recent period, the nature of the leverage business has begun to change. This is of critical importance in a particular area in that the—

Chairman ROTH. Particularly important to those four firms, I assume.

Mr. JOHNSON. We have asked for a moratorium, Mr. Chairman, on that because we certainly don't know how our final recommendation will come out, and we feel it would be unfortunate to admit more firms only to have them banned at the end of the study.

Chairman ROTH. I must say. It concerns me maybe there is some adequate reason for a two-year study, but when three of the five commissioners will be departing by that time, it looks like not much action will be taken.

I go back to the question I raised with respect to the question of the States. Why shouldn't the States have jurisdiction over these contracts? Are leverage contracts illegal under State bucket shop damage statutes because they are not traded on an exchange and there is no intent to deliver?

Mr. JOHNSON. I don't have an answer to that, Mr. Chairman. I am not sufficiently acquainted with State bucket-shop laws. I know they vary quite a bit. I don't have an answer to that.¹³²

State securities administrators have, however, evidenced a strong desire to assume the regulatory responsibilities over leverage contracts. Massachusetts Securities Commissioner Michael Unger, speaking on behalf of the North American Securities Administrators Association (NASAA) told the Subcommittee:

(L)everage contracts . . . currently are not subject to state legislation. NASAA's position is that they should be. This is no logical reason why they shouldn't be treated as securities. There is an exception carved out in the CEA which permits leverage contracts to be regulated by the CFTC. Many of those firms, in fact, practice boiler room tactics. They should be registered and policed by the states. CFTC can do it as well, but we would like to do that.¹³³

¹³² Hearings, pp. 136-137.

¹³³ Hearings, p. 111.

Since the 1978 moratorium, the leverage firms have sold more than \$5 billion worth of contracts. In response to questions put forth by Chairman Roth these firms have indicated some astronomical salaries and commissions paid to salesmen.¹³⁴ One firm put the average figure paid in 1980 at more than \$86,000, another at more than \$79,000. Some of these firms employ almost 100 salesmen.

In July 1976, the CFTC Advisory Committee on Market Instruments considered the question of whether leverage contracts themselves were inherently fraudulent. After much consideration, the Committee determined it could not conclusively state that leverage transactions could not operate legitimately.¹³⁵ The Committee did not, however, indicate how this legitimate operation could be assured.

As previously noted, the four leverage firms have consistently ranked among the top 12 firms against which the Hearings Section of the CFTC receives the most complaints. These complaints have also tended to involve larger amounts of money than other contracts, averaging over \$100,000, far greater than the average amounts claimed in the same period for futures, pools and off-exchange contracts combined.

COMMODITY OPTIONS

Another area examined by the Subcommittee was the regulation of commodity options. A commodity option differs from a futures contract in that a futures contract creates a duty to buy or sell at a future date, whereas an option entitles a person to buy or sell at a future date if he so chooses. If the commodity on which the option applies moves in a favorable direction the option will be exercised and the commodity bought or sold. If the commodity moves unfavorably the option is waived and no commodity is bought or sold.

It is this waiver which makes options particularly enticing to the investor and, hence, susceptible to fraud. An unscrupulous operator can usually convince a client that there have been unfavorable moves, no matter what actually occurs in the market. Even if favorable moves are obvious, carrying fees, trading fees or some other costs can be fabricated which may render exercising the option financially impractical. If a scam operator can convince the client that he should not exercise his option, then the operator will not have to "cover" (i.e. purchase the option). If the options never have to be covered, all the scam operator has to do is offer "naked" options for sale and watch the money roll in.

This is exactly what happened in the mid-1970's. Rapidly growing operations which claimed to sell options but actually sold worthless paper defrauded customers nationwide. Congress reacted by banning commodity options in the United States. Section 4c(c) of the Commodity Exchange Act, 7 U.S.C. § 6c(c) (Supp. II 1979) prohibits the offer and sale of any commodity options until the Commission provides Congress with evidence that such transactions can be regulated successfully. In 1981, the Commission adopted regulations reauthorizing the

¹³⁴ Letter from Mark S. Lieberman, General Counsel of Premex, Inc., to Senator William V. Roth, Jr., February 11, 1982; Letter from David Simon, Counsel to First National Monetary Corp., to PSI Staff Counsel Carolyn Herman, January 19, 1982; Letter from Gregory C. Walker, Counsel to Monex, Inc., to Senator William V. Roth, Jr., January 14, 1982; Letter from James J. Groberg, Chairman of the Board of the International Precious Metals Corp., to Senator William V. Roth, Jr., January 18, 1982.

¹³⁵ Advisory Committee on Market Instruments. Recommendation by Futures, Forward and Leverage Contracts Subcommittee, p. 5, footnote 4, and Exhibit I-A (1976).

trading of options on futures contracts on the commodity exchanges. Accompanying these regulations was a "justification" of the proposed program, including the CFTC plan for its regulation.

The pilot options programs

The CFTC Pilot Options Program is limited to a four-year period. Only registered persons may trade specifically approved options on those exchanges approved by the CFTC. These limitations, coupled with certain restrictions on futures commission merchants, are the bulwark of the Commission's options regulations. It is hoped that options will be so limited that they will be easy to regulate. At the same time, however, options are being allowed only because they allegedly serve an important economic purpose. In fact, even before Congress has approved the program, eight exchanges have applied to trade options on commodity futures contracts on gold, platinum, sugar, bank certificates of deposit and Treasury Bills.

During its investigation, the Subcommittee learned that the advent of options is also anticipated by fraudulent operators. Subcommittee investigators, while interviewing several convicted commodity swindlers who had kept in contact with swindlers outside of prison, discovered that fraudulent operators anxiously await the moment Congress says that options are not illegal.

Senator Rudman explored this area with Raymond Day, the convicted operator of Archaray Enterprises, a commodity fraud operation which took in \$2.5 million in one year:

Senator RUDMAN. Mr. Day, there is a pilot program that is going on at this time that would allow certain options to be sold on legitimate futures. What effect do you think that this will have on legitimate operators?

Mr. DAY. It will be a field day for illegitimate operators. First, the public will know that it is legal to trade options, so when they get a call from an illegal operator, they will think they are legal initially. It doesn't matter how much they pay for the option, for even if the option is stated in the newspaper for \$3,000 here and you are going to charge the guy \$7,000.

It doesn't matter. What it will do, in effect, is make it easier for the illegitimate operator to sell that person.¹³⁶

Law enforcement officials interviewed by the Subcommittee also believe that official approval of options trading will open the floodgates of options boiler rooms nationwide. For example, one New York official advised that intelligence information indicated that New York telephone rooms were anxiously awaiting the opening of the options pilot program. Moreover, commentators have expressed other serious concerns about options trading in today's environment, as evidenced in this exchange between Commissioner Krebs of Alabama and PSI's Chief Counsel:

Mr. WEILAND. One question for Mr. Krebs. The staff is also aware of the historical problem regarding the sale of options in the United States, a series of large-scale frauds that have arisen over the years with respect to options marketing.

¹³⁶ Hearing, p. 78.

Can you comment, Mr. Krebs, from your open experience, as to what you feel may develop with respect to the recent decision to begin marketing options again in the United States?

Mr. KREBS. Where is it going to stop? Where is that an economic benefit to this country? We have options on futures contracts, and now we are going to have futures on the stock index. We may as well start selling options on tulips or may as well start selling options on the mean temperature in the city of Los Angeles. It has got to have some relevance to our economy.

I have firms in Alabama now that are going bankrupt for want of capital. Why not try to encourage investment capital for these firms so we can put our people back to work instead of, in essence, institutionalizing a ponzi scheme or having national gambling contracts. If we are going to have a national lottery, let's call it that. That is, in essence, what these type contracts are.¹³⁷

The Commission's justification of the options program promises that the CFTC "will perform a vigilant oversight role,"¹³⁸ but conspicuously avoids mentioning how the Commission will handle options fraud. The justification states only that "sales practice which are fraudulent or high pressured and wash sales and bucketing are prohibited."¹³⁹ Since an assortment of Commission prohibitions are routinely ignored by commodity bandits, there is no particular reason to believe the Commission will be spared this time. Much is said about market surveillance, the limitations on the pilot program's size and registration of traders, but nowhere does the Commission say how this overworked, understaffed agency, unable to handle its present authority, will be able to police the additional program. In the justification of the options program, the CFTC anticipates that, if the Commission is unable to stop options fraud, the states will be allowed to assist,¹⁴⁰ but only under circumstances which severely limit state authority and hamper the exchange of information. The Commission's justification simply speaks in sweeping generalities, such as in the nation that the Commission will obtain additional resources by "efficient allocation".¹⁴¹

Can the CFTC handle options in 1982

In a June 1, 1981 memorandum to the Commission (Hearing Exhibit 8, reprinted in Appendix) the Director of the Division of Enforcement stated that the CFTC could not effectively regulate a pilot options program and recommended that the program not be adopted. In his memorandum, Enforcement Director Loughran stated that "any lifting of the options ban will most likely increase the activity of persons selling illegal options and thus the burden on the Commission's enforcement program." Mr. Loughran said that without a transaction

¹³⁷ Hearings, p. 46.

¹³⁸ CFTC Regulation of Domestic Exchange-Traded Commodity Options, Justification, p. 23.

¹³⁹ *Supra*, footnote 138, p. 15. "Wash sale" refers to "the operation of simultaneously buying and selling the same stock" or, in this case, commodity. See Black's Law Dictionary 1750 (4th Ed. 1968). "Bucketing" refers to the "receipt of orders to purchase and sell stock without intention of executing orders and with execution of orders." See Black's, 243.

¹⁴⁰ *Supra*, footnote 138, p. 24.

¹⁴¹ "The stresses on Commission resources . . . will depend on presently undefinable circumstances." *Supra*, footnote 138, p. 25.

reporting system and suitability rules the options program regulatory scheme is inadequate. However, neither of the proposals of the Director of the Division of Enforcement was included in the Commission's proposed options regulations. Mr. Loughran still holds reservations about the ability of the CFTC to address fraud in the options program:

Senator RUDMAN. My question to Mr. Loughran is simply, were either of the recommendations that were embodied in your June 1 memorandum to the Commission adopted and now part of the pilot (option) program?

Mr. LOUGHRAN. Senator, neither of the recommendations was adopted totally. I can say that the Commission was responsive to my concerns about suitability, perhaps not as responsive as I might have liked, but I will say responsive of the duties which suitability and attendant record keeping rules generally impose...

Senator RUDMAN. Mr. Loughran, do you still hold your reservations about this pilot program as Chief of the Enforcement Division?

Mr. LOUGHRAN. Sir, I have to hold my reservations about it. I always have to. Any new product concerns me, and I have to, Senator.¹⁴²

In a May 29, 1981 memorandum to the Commission, Donald L. Tendrick, then Executive Director of the CFTC, concluded that the implementation of an options program would mean that already scarce resources at the Commission would have to be diverted from other programs:

Presently, it is not possible to estimate the resource needs for options as the full scope of the program has not been clearly established. . . . (I)f the Commission approves an options program, further curtailment of ongoing programs will be necessary. . . . This question is also important when by law we must present documentation of our ability to regulate options to Congress. (Hearing Exhibit 20, reprinted in Appendix.)

In essence, the CFTC does not have the resources to operate an options program and would have to pilfer resources from the other areas of the CFTC already operating on the bare minimum. The CFTC, which openly admits that it cannot fully handle its present enforcement responsibilities, is thus implementing a questionable program that will further weaken its existing anti-fraud activities.

The CFTC rests the potential regulatory effectiveness of the options program on the precarious foundation of existing commodity regulation programs: enforcement and registration. But, CFTC Enforcement is understaffed and overworked, and the number of investigations undertaken by the Division has decreased in recent years. The Registration operation, also limited in resources, provides no effective obstacle to fraud; in fact, it facilitates fraud. In the meantime, the Commission intends for its audit programs to prevent option fraud. Given CFTC resources, the Subcommittee finds this unlikely; as

¹⁴² Hearings, p. 129.

Chairman Roth pointed out in questioning the Commission's audit capabilities, "I, frankly, find it rather difficult to believe that with six auditors you can monitor 800 (commodity) pools very closely."¹⁴³

Furthermore, it cannot be ignored that resource problems within the Commission's Enforcement Division plague the so-called Market Integrity Section as well as the Customer Protection Section. The Market Integrity Section deals with policing actual trading and has had, among other responsibilities the mandate to attempt to unravel the silver crisis of 1979-1980, the investigation of disruptions in the coffee market, the negotiation of the Hunt brothers soybean case, the study of trading irregularities at the New York Mercantile Exchange and the investigation of reporting violations of foreign traders. To accomplish these tasks, the Market Integrity Section is equipped with roughly the same number of attorneys and investigators as assigned to the Consumer Protection side. Since the trading of options presents additional opportunities for market disruption by virtue of a squeeze or manipulation, the pressure on the Market Integrity Section can be expected to increase significantly. Absent an infusion of substantial additional resources, the Subcommittee concludes that the Enforcement Division will be unable to cope with the market integrity problem presented by the trading of options.

Chairman Johnson told the Subcommittee: "we will simply have to deal with the rabble rousing edge in the way that we always deal with that element."¹⁴⁴ But these are not "rabble rousers" merely pulling childish pranks, they are organized criminals who calously bilk the public out of thousands of dollars each month. The way that the CFTC "always deals with that element" has simply been inadequate.

At the same time, the pilot options program relies on the exchanges themselves for direct and primary regulatory responsibility. The pilot program will require the boards of trade to adopt and maintain comprehensive rules and programs to assure that its members comply with those rules. In this scheme, the markets themselves will have the primary responsibility for ensuring that their members are operating within the parameters set by the CFTC to provide for legitimate trading of commodity options.

Even before the options program has become operational, however, the rules promulgated by contract markets have proven to be inadequate. In March, 1982, John Manley, the Director of the CFTC Division of Trading and Markets, found that these rules were deficient in establishing detailed sales practice audit programs, explaining the clearing of option margins on a gross basis, and preventing abuses by floor traders.¹⁴⁵ Another deficiency found by Director Manley, the failure to provide for the timely dissemination of market and transaction quotes, is uncomfortably similar to the principal reason for the vast option fraud in the mid-1970's, that is, the inability of customers to get an accurate report on the market and their own trading. Also, in March of 1982, the Federal Reserve Board ruled that the proposed three-month Treasury Bill futures option contracts of the New York Futures Exchange failed to meet the CFTC established criteria that

¹⁴³ Hearings, p. 122.

¹⁴⁴ Hearings, p. 123.

¹⁴⁵ *Commodity News Service*, Mar. 4, 1982, p. 9.

requires "sufficient liquidity to prevent disruption of cash and future markets."¹⁴⁶

In the CFTC Option Pilot Program, the CFTC hopes that, by limiting options trading to the contract markets, the markets themselves will regulate options. The CFTC will not, however, require the exchanges to adopt any surveillance or antifraud systems in areas other than sales that are not already in effect on the exchanges.¹⁴⁷ The CFTC is thus responding to the Congressional mandate that the Commission prove itself capable of regulating options by shifting that regulatory responsibility to the exchanges, while at the same time requiring no new anti-fraud measures to be undertaken.

Thus, the Commission has lifted the options ban at a time when it has even less regulatory resources to deal with options fraud than when the ban was first imposed. It has not assumed the regulatory position which Congress intended, but rather has delegated virtually all of this responsibility to the markets. The Commission, which has moved so cautiously in the more limited area of leverage contract—after lengthy and superfluous study—has chosen to plunge headlong into the much deeper sea of options trading—a hazardous area in which Congress has expressed great concern.

Stock index futures

The CFTC has recently approved a multitude of new futures contracts. The approval of highly speculative and controversial contracts on stock market indexes is especially noteworthy. These instruments are similar to other futures contracts in that the investor purchases a contract with the expectation that the underlying price will rise, and sells with the expectation that the underlying price will decline. Stock index futures differ from other futures contracts in that the underlying commodity is not traded; actual delivery is made only in cash.

During the Subcommittee hearings, one securities commissioner categorized these contracts as "national gambling contracts."¹⁴⁸ Senator Rudman reiterated this position later in the hearings when he suggested that a futures contract on stock market indexes were "essentially not much different from a national lottery."¹⁴⁹

The Subcommittee is troubled with the introduction of such speculative contracts in light of the present inability of the Commission to adequately police the industry. Additionally the Subcommittee shares a concern of the Federal Reserve Board that the CFTC, unlike the SEC in similar contracts, has not implemented margin requirements.¹⁵⁰ At a time when investments are desperately needed in productive assets, the Subcommittee cannot help but question the economic justification of futures contracts on stock indexes.

COMMODITY POOLS

A commodity pool is "any investment trust, syndicate or similar form of enterprise that trades commodity interests."¹⁵¹ Investors pool their funds into a single account which is entrusted to a commodity

¹⁴⁶ Commodity News Service, Mar. 29, 1982, p. 8.

¹⁴⁷ Supra, footnote 138, p. 8.

¹⁴⁸ See supra, footnote 137.

¹⁴⁹ Hearings, p. 133.

¹⁵⁰ "CFTC is on the Road to Extinction," Chicago Sun Times, February 16, 1982.

¹⁵¹ 17 C.F.R. Section 4.10(d).

pool operator (CPO). The commodity pool operator uses the pooled funds to buy and sell commodity futures contracts. If the trades are successful, then the investors in the pool will share any profits in proportion to the amount they have contributed. A commodity pool is very similar to a mutual fund which deals in commodities rather than securities.

Commodity pools are created to provide smaller investors with the clout of a large trading account while freeing the investors from constant market monitoring. The pool members allow the pool operator to trade as his experience dictates. While this trust permits the legitimate commodity pool operator to allocate more time to the trading accounts, it may also free the unscrupulous operator from providing trading information to the members of the pool. A pool operator who wishes to defraud the pool members may do so in several ways. Because the operator provides trading information to the pool participants, he can easily fabricate trading results, reporting losses where profits were made and pocketing the profits. He may skip the risks of trading altogether, report fictitious trading losses and pocket everything. He may charge the participants management fees for fictitious trades and slowly drain the pool funds for services allegedly rendered, a process known as "churning." Another phenomenon involves kickbacks from commodity brokers (FCM's) to CPO's in exchange for CPO business.

The potential for abuse and the requisite trust in a pool operator would suggest that there are stringent requirements and safeguards in the registration of a commodity pool operator. This, however, is not the case. To become a federally registered commodity pool operator a person need only fill out an application form and pay a \$50 registration fee. No financial requirements exist, as do for futures commission merchants. There is no requirement that the applicant have any commodity trading experience or even rudimentary trading knowledge. The employees and agents of CPO's do not have to register with the CFTC nor do pools with fewer than 15 members and less than \$200,000 in gross capital contributions.

Even with these limitations, 827 commodity pools were registered with the CFTC in fiscal year 1981.¹⁵² The number of pools that need not be registered or simply operate without registration is undeterminable. Robert Isaacson, Director of the National Association of Futures Trading Advisors (NAFTA) believes that there are about 1,700 commodity pools and that the problem of crooked operators is growing.¹⁵³ CFTC Director of Trading and Markets John Manley has stated that the CFTC has devoted more and more time and effort in closing down crooked pools but that "the ranks of these crooked operators seems to grow with the general expansion of these companies and services."¹⁵⁴

The extent of this fraud is enormous. Chilcott Commodities Corporation and affiliated concerns operated in Fort Collins, Colorado for seven years and supposedly took in between \$50 and \$70 million dollars. In 1981, the CFTC and FBI moved in but found less than \$7 million in assets. The pool and its president, Thomas Chilcott, al-

¹⁵² Source: CFTC Registration Statistics 10/27/81, page 1, Section 1a.

¹⁵³ H. J. Maldenberg, "Commodity Pools: the Next Scandal?", *Commodities Magazine*, February, 1982, p. 76.

¹⁵⁴ *Supra*, footnote 153, *Id.* p. 78.

legedly solicited money to invest in commodity futures contracts. Chilcott then, allegedly, diverted large sums for his personal benefit or for activities unrelated to commodities trading.¹⁵⁵ Ashton and St. John Inc., a New York pool run by former electrician and fried chicken salesman, Wilbert Wilson, took in over \$3,750,000 from 800 customers in approximately one year. Only 20% of all money taken in was invested in futures contracts; the rest went to Wilson and his salesmen. On October 31, 1980, an 82 count indictment was filed against Wilson in the Southern District of New York. Wilson is currently a fugitive.

The Better Business Bureau of Metropolitan New York, an organization that has been extremely active in monitoring fraudulent commodity sales operations, has already discovered a proliferation of fraudulent commodity pool schemes in 1982.¹⁵⁶ These pools have been found to: fail to disclose fees, commissions and charges; never actually effectuate trades; and misrepresent such vital areas as the firm's history, investors' profits and the security of the investment. The Bureau has also found that fraudulent pool operators use their registration with the CFTC as a license to steal.¹⁵⁷ As a result, the Bureau has suggested that local and state law enforcement agencies should be encouraged to move more aggressively to combat such fraud.

Michael Collora, receiver for the North East Investment Company and the Boston Trading Group, told the Subcommittee:

I am the receiver of two commodity pool operators where the principals are alleged to have churned approximately \$6 million down to several thousand in the period of several months. All the churning resulted solely in commissions to themselves, they disappeared. The money has disappeared and the investors have been unable to find out what happened.¹⁵⁸

The states can provide a valuable service in thwarting commodity pool fraud in the use of their Blue Sky laws to ensure that there are adequate safeguards during the initial or capital formation stage of the pool. As defined by the CFTC, a pool is an investment contract or similar enterprise that trades commodity contracts. In these operations, people invest money with the understanding that profits are expected from the sole efforts of the pool operator. Until the time that commodity contracts are traded, there are no substantive differences between a commodity pool and any other investment contract. Thus, the capital formation stage of a commodity pool is no different from the capital formation stage of any other venture.

Some states¹⁵⁹ therefore, have attempted to regulate the capital formation of a commodity pool under their Blue Sky laws as they would any other investment contract. These states supplement CFTC registration requirements for pools by requiring more extensive information about the qualifications and suitability of the pool operator and the method of doing business. The pool operator, in his capacity as a

¹⁵⁵ See Complaint in *CFTC v. Chilcott Portfolio Management, Inc., et al.*, Civ. No. 81-999 (D. Col. 1981).

¹⁵⁶ Hearings (Statement of Karl F. Lauby, Vice President of the Better Business Bureau of Metropolitan New York, Inc.) (Exhibit # 11).

¹⁵⁷ *Id.*

¹⁵⁸ Hearings, p. 104.

¹⁵⁹ Arkansas, California, Florida, Iowa, Maryland, Minnesota, New York, Oklahoma, South Dakota, Tennessee, Texas and Wisconsin.

dealer of an investment contract, may be required to be bonded. Additional requirements may be imposed on agents and employees of the pool.

These requirements are not special penalties for commodity pools, but rather the basic information which the state may require to ensure the integrity of any business concern. Through the use of Blue Sky laws, the states may supplement the beleaguered CFTC by requiring commodity pools, in their capital formation stage, to provide information upon which the investors can more adequately examine their investment. To preempt the states from this role¹⁰⁰ would mean eliminating a valuable service and further burden the strained resources of the CFTC.

SELF-REGULATION

The Subcommittee does not offer any conclusions as to the self-regulatory ability of the commodity futures trading industry. Certain observations can be made however. Under the Commodity Exchange Act, contract markets must implement trading rules, subject to the approval of the CFTC.¹⁰¹ These rules encompass record keeping, financial requirements, warehouse operation and receipts, conformity of commodity and other rules and bylaws relating to the terms and conditions in contracts of sales executed on that exchange. The failure of any board of trade to comply with any provisions of the CEA or any CFTC approved contract market rule is cause for suspension or revocation of the authorization to operate as an approval contract market.

Presently, the self-regulatory duties of the contract markets have been carried out by each individual exchange. There is currently no comprehensive self-regulatory body in the commodities area which has the sufficient membership and structure to coordinate these self-regulatory efforts in the same or similar way that the National Association of Securities Dealers coordinates self-regulation in securities trading. The CEA, however, in Section 17, provides for the implementation of a registered futures association to fill this role and operate in the public interest. Section 17 provides strict guidelines as to the conduct of any such association and specifies particular regulatory guidelines which a registered futures association must follow.

On March 16, 1981, the National Futures Association (NFA) submitted an application to the CFTC for registration as a registered futures association. In June of 1981, public hearings were held by the CFTC to invite public comment on the NFA application and for the Commission to request clarification of certain provisions of the NEA application. Afterwards, the CFTC issued an order granting registration and approving the rules of the NFA.

As prescribed in Article III, the NFA's fundamental purpose includes implementation of comprehensive regulatory programs with respect to the commodities industry. The NFA intends to develop standards for registration of traders, auditing and surveillance. Several have been proposed which are designed to protect against the insolvency, bankruptcy or unsound financial condition of NFA mem-

¹⁰⁰ Senator Jesse Helms has suggested amendments and report language to S. 2109 which would preclude the states from dealing with commodity pools in any fashion.

¹⁰¹ *Supra*, footnote 14, § 5a(1).

bers. Certain customer protection provisions have been proposed including sales practice standards and the institution of an arbitration procedure for the settlement of customer claims.

As the NFA assumes regulatory responsibility, the CFTC expects to reallocate its resources to provide greater review of existing programs and more vigilant anti-fraud enforcement. At the same time, however, the NFA proposal does not provide for immediate implementation of its regulatory program. Even the most optimistic supporter admits it will take over a year to implement a skeletal organization, with full operation several years in the future. The NFA proposal does not even purport to detail all self-regulatory functions that the NFA plans to assume.

Another obstacle in the path of the NFA is the question of funding. The NFA proposes that its funding be derived from dues paid by its members. At the same time, however, there is a growing movement to finance the CFTC from additional fees charged commodity traders.¹⁶² These user fees are based on the concept that those persons who use the commodity contract markets should bear the burden of their own regulation.

A basic premise of the NFA concept is that a significant portion of the industry will join the NFA, thereby submitting itself to a self-regulatory authority that can significantly affect the entire industry. In order to promote membership, the NFA proposes to prohibit its members from trading with non-members. NFA proponents hope that most of the contract markets will join to ensure that other commodity traders will not refuse to trade with them. It is unclear, however, whether such trading restrictions are legal or whether they may constitute an illegal restraint of trade. Similarly, doubts have been raised about the ability of futures exchanges to veto the Association by-laws and the ability of large concerns to obtain greater control over the NFA by superior voting power.

While the creation of the NFA is laudable, it is only at a fledgling stage. Though the industry may purport that "(a)t the present time, industry support for an NFA is at the highest level since its inception,"¹⁶³ the rule making powers, funding, and jurisdiction of the NFA are presently theoretical. Not one individual, corporation or other concern has yet become an NFA member. As a result, regulatory enforcement cannot be effectively undertaken by the NFA at this time. Furthermore, there is no indication that the NFA will soon be able to accept the responsibility of sales practice supervision.¹⁶⁴ Even if it realizes its greatest potential, acquiring all of the power which its most optimistic proponents suggest, the NFA will merely complement the CFTC, not assume the CFTC regulatory mandate.¹⁶⁵ Thus, regulatory problems cannot be dismissed simply because the NFA will deal with some aspect of the problem.

¹⁶² See e.g. S. 2109, Section 22 (original CFTC bill introduced by Senators Helms and Lugar.)

¹⁶³ *Supra*, footnote 43 (Senate Hearings) (Statement of David Johnston, Sr., Vice President of E. F. Hutton and Company, Inc.).

¹⁶⁴ *Supra*, footnote 128 (February 23, 1982 Letter from Commissioner Stone).

¹⁶⁵ As noted by Massachusetts Securities Commissioner Michael Unger in testimony before the Subcommittee. "The National Futures Association is going to be an industry-controlled group. There are many good things they can do, such as audit functions and perhaps registration functions, but they will not be a panacea for the fraud that exists. We just do not see that happening." Hearings, p. 112.

SUMMARY

The Permanent Subcommittee on Investigations has undertaken an extensive and continuing examination of commodity fraud in the United States. The Subcommittee has found, during the initial eight-months of this investigation, that thousands of persons nationwide have been victimized by fraudulent commodity sales operations marketing various commodity futures instruments, including deferred delivery contracts, forward delivery contracts, margin contracts, commodity pools or simply commodity trading advice. In the past five years these commodity schemes have defrauded the American public of over \$1 billion. The operators of these scams are drawn to the business by large profits and a slight chance of criminal prosecution. Principals and salesmen move freely from one operation to the next, avoiding prosecution and "earning" huge undeclared incomes. Firms which operate for only short periods of time may still succeed in bilking investors out of hundreds of thousands of dollars.

Frequently the perpetrators are registered with the CFTC, acquiring a credibility with potential investors which they otherwise could not obtain. The Registration Unit of the CFTC is woefully understaffed and is unable to effectively screen every person who is not suitable for trading. Equally outgunned, the Enforcement Division has had considerable trouble just dealing with major crises. Relatively small operations often slip through the cracks. Once the customer has been victimized, the Reparations procedure offers a complex procedural maze, long delays, inconsistent verdicts, slight chance of an award and less chance of ever receiving payment on the award.

The CFTC has been unable to stem the recent tide of commodity frauds, yet it systematically authorizes new areas of trading which may be subject to ever increasing fraud. Commodity options, banned in 1978 because of their susceptibility to fraud, are being reintroduced into the markets. New and exotic contracts, such as stock index futures, have been approved for trade. Leverage contracts, still under the exclusive jurisdiction of the CFTC, remain free of regulation. Meanwhile, states anxious to protect their citizens are forbidden to enact commodity fraud legislation or to enforce their existing securities laws to allow them to effectively join in the fight against commodity fraud.

RECOMMENDATIONS

On the basis of the foregoing evidence and conclusions, the Permanent Subcommittee on Investigations recommends the following:

1. Elimination of restrictions against state efforts to prosecute commodity fraud;
2. Elimination of restrictions which prevent the CFTC from sharing information with the states or foreign governments;
3. Vastly more effective CFTC registration;
4. A private right of action in federal and state courts for commodity customers;
5. Comprehensive regulation of all types of off-exchange contracts on the federal and state levels;
6. More effective tools and resources for the Enforcement Division, including the use of *ex parte* orders where warranted; and

7. A continued ban on commodity options until such time as the CFTC can prove to Congress that such contracts can be effectively regulated by federal or state authorities.

Some of these recommendations are embodied in legislation introduced by Senators Roth and Rudman, co-sponsored by Senators Nunn and Chiles, all Members of the Subcommittee. This bill, S. 2210, known as the Commodity Exchange Act Fraud Amendments of 1982, has since been co-sponsored by Senators Proxmire and Stevens and has been referred to the Senate Committee on Agriculture, Nutrition and Forestry.

In light of the growing extent of commodity related fraud and the constraint of CFTC resources, it is clear that the existing regulatory framework for commodity trading must be supplemented. Self-regulation via the NFA is still somewhat distant and is not likely to affect fly-by-night illegal boiler rooms, of which the Subcommittee found a chilling prevalence.

1. STATE JURISDICTION

States have shown themselves willing to combat this type of fraud but are precluded by a statutorily mandated federal preemption. Currently empowered under their Blue Sky laws to counter securities fraud, the states have evidenced a desire to undertake a similar role in commodity fraud. Under the Commodity Exchange Act, however, they are precluded from enacting statutes dealing with commodity fraud. The awkward enforcement procedures which have been accorded to the states are ineffective and unworkable.

The natural desire of law enforcement officials to do their jobs, and the CFTC's proven ineffectiveness has created internal, constituent-related pressures on state authorities. The Subcommittee recommends a partial lifting of the CEA's preemption to permit the use of state securities anti-fraud provisions against registered and unregistered commodity dealers except for contract markets, clearinghouses or floor brokers.

2. SHARING INFORMATION

A crucial aspect of effective concurrent off-exchange regulation by the federal and state governments is the free exchange of information. The one-way flow of data from the states to the CFTC pursuant to 8(e) of the CEA must be changed so that the states may obtain information from the Commission. Legislative proposals before the Agriculture Committee would essentially accomplish this.

3. REGISTRATION

As it currently exists, CFTC registration does not adequately ensure that only suitable and competent persons be allowed to advise and trade in commodity futures contracts. While it is proposed that the National Futures Association will assume a great deal of the registration duties of the Commission, the present problems cannot be allowed to continue until the NFA is able to act. A comprehensive CFTC registration procedure is required, with more complete review of applications for registration. The Congressionally mandated fingerprinting and qualification testing programs must be implemented.

The Roth-Rudman bill, S. 2210, also provides a unique means of allowing the states to assist in both the enforcement and registration of all registered persons. In this bill, the registered person shall, before conducting that business for which he was registered, inform the Commission of the states in which that registered person plans to conduct business. Within 60 days, the Commission shall notify the appropriate state official of the intent of the registered person to do business in that state. The state may then petition the Commission to suspend or revoke the registration if cause exists pursuant to the Act. If a state does not wish to be so informed of registered persons it would simply not designate any "appropriate official." The Subcommittee recommends that Congress consider this device as a reasonable solution to the problem.

4. PRIVATE RIGHT OF ACTION

On May 3, 1982, U.S. Supreme Court, in the case of *Merrill Lynch v. Curran*, No. 80-203 (U.S. cert. granted April 20, 1982); and *New York Merchantile Exchange v. Leist*, Nos. 80-757, 80-895 and 80-936 (U.S., cert. granted February 23, 1981) held that a private right of action does exist under the Commodity Exchange Act. In a five-to-four decision, the Court found that purchasers and sellers of futures contracts have standing to assert both types of claims: violations of statutory prohibition against fraudulent and deceptive conduct, and the provisions designed to prevent price manipulation. The CFTC, in *amicus curiae* briefs for both the *Curran* and *Leist* cases, has argued that such a private right of action was known by Congress to exist in 1978 and that the failure of Congress to change that status was an implicit acceptance of a private right of action. The court obviously found this argument to be persuasive, and relied heavily on the failure of Congress to alter the statute once a private right of action had been inferred.

The decision will allow actions to now be brought before federal district court by commodity customers who feel they have been defrauded, rather than proceeding in the Reparations Section of the CFTC, a process which is often erratic, overburdened and rarely effective. This decision offers one possible solution to the background and ineffectiveness of the CFTC reparations program, and the Subcommittee opposes legislative proposals which would infringe upon a private right of action.

5. OFF-EXCHANGE CONTRACTS

While it may be argued that state regulation of all futures trading would pose a heavy burden on the huge commodity industry, no compelling reason exists to preclude states from regulating trading that is not carried out directly on national exchanges. To the contrary, states can provide the extensive, local level regulation which is needed to combat the growing number of boiler room commodity sales which systematically defraud the public of hundreds of millions of dollars each year. Congress should provide the states with concurrent jurisdiction over leverage and any other commodity contract which is not traded on a Commission approved contract market where marketing problems have been shown to exist.

6. ENFORCEMENT

The Subcommittee has found problems with respect to enforcement of the Commodity Exchange Act by the CFTC. The CFTC Enforcement Division is not capable of dealing with the current level of fraud, much less the avalanche of problems presented by new contracts. Additional resources must be dedicated at CFTC enforcement efforts. States should be given off-exchange jurisdiction and the limited securities anti-fraud jurisdiction outlined above. In addition, Congress should eliminate the prohibition of the use of *ex parte* orders by the CFTC in Section 6c of the CEA (7 USC 12 a-1). An *ex parte* is an order which is granted for the benefit of one part only, without notice to or contestation by any person adversely interested. *Ex parte* orders are a regular part of judicial procedure and their use is sanctioned by the Federal Rules of Civil Procedure, yet the CFTC lacks the statutory authority to use this special tool in those particular instances where a court feels they are warranted.

The Subcommittee has found that, in order to combat the nomadic boiler room commodity scams, the regulatory authority of commodity trading should be able to quickly act upon information received. It is the opinion of this Subcommittee that regulators of commodity trading should be empowered to respond to instances of fraud as soon and as effectively as possible.

7. OPTIONS

It is the recommendation of this Subcommittee that commodity options contracts remain banned until such time as the CFTC can provide convincing evidence of its own ability to regulate such transactions, as required by Section 4c of the Commodity Exchange Act. That section requires that the CFTC document its ability to regulate options. A proposal to merely delegate responsibility to the markets and to the as yet non-viable NFA is insufficient. The history of fraud in this area compels more caution.

CONCLUSION

In the past five years, commodity futures trading has grown enormously. Battered by inflation, investors have been enticed by the allure of commodity investments. Once the private domain of farmers and industrialists, commodity futures trading has exploded into a far reaching galaxy of contracts affecting almost every aspect of daily living.

As in any successful industry, however, a certain number of unscrupulous individuals have succeeded in using the commodity boom as a screen for executing fraudulent schemes. Realizing the vast potential for commodity fraud, Congress created the Commodity Futures Trading Commission in 1974 to regulate commodity trading. The Commission, despite determined leadership in recent years, has been unable to adequately perform the job for which it was created, primarily due to limited resources. Federal preemption of regulation has stripped states of vital police powers. As a result, commodity fraud has grown to epidemic proportions, worth hundreds of millions of investors' dollars being lost each year.

The federal regulatory scheme for commodity futures trading does not work. The CFTC cannot police the legitimate marketplace and simultaneously combat commodity crime nationwide. At the same time, budgetary constraints preclude great expansion of resources. The roles of the CFTC and other law enforcement agencies, state and federal, must be re-examined. The CFTC cannot do the job alone.

The following Senators, who were Members of the Permanent Subcommittee on Investigations at the time the hearings were held have approved this report:

William V. Roth, Jr.
Warren B. Rudman
John C. Danforth

Sam Nunn
Henry M. Jackson ¹
Lawton Chiles
Jim Sasser

The Members of the Committee on Governmental Affairs, except those who were members of the Senate Permanent Subcommittee on Investigations at the time of the hearings, did not attend the hearings on which the above report was prepared. Under these circumstances, they have taken no part in the preparation and submission of the report except to authorize its filing as a report made by the Subcommittee.

¹ See Additional Views of Senator Jackson on page 54.

ADDITIONAL VIEWS OF SENATOR HENRY M. JACKSON

I approve of the printing of this Subcommittee Report; however, I reserve judgment concerning the specific legislative recommendations included in the Report.

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APPENDIX

COMMODITY FUTURES TRADING COMMISSION,
OFFICE OF THE EXECUTIVE DIRECTOR,
Washington, D.C.

Memorandum for: The Commission.
From: Donald L. Tendick, Executive Director.
Subject: Resources to the Options Pilot Program.

At a meeting now scheduled for Tuesday, June 2, the Commission will be considering a proposal on exchange-traded options regulations. As part of that consideration, the Commission should keep in mind the question of priorities and resources. Presently, it is not possible to estimate the resource needs for options as the full scope of the program has not been clearly established. In view of the fact that the Commission's personnel ceiling for fiscal year 1982 has been reduced by 40 positions to 470 full-time permanent positions, present ongoing activities will have to be curtailed in order to absorb this decrease in personnel. In addition, if the Commission approves an options program, further curtailment of ongoing programs will be necessary. Also, the fiscal year 1982 resource projections did not include estimates for the Commission to regulate leverage and dealer option transactions.

While the question of resources will not be resolved at the June 2 meeting, it must be considered by the Commission and decided upon by the Commission prior to the adoption of any final regulatory package for exchange-traded options. This question is also important when by law we must present documentation of our ability to regulate options to Congress.

Files on earlier staffing projections are available if anyone desires to review them.

CONFIDENTIAL MEMORANDUM, JUNE 1, 1981

To: The Commission.
From: Division of Enforcement.
Re: Options Pilot Program.

The Commission will consider the options pilot program at an open meeting on June 2, 1981. The Division of Enforcement believes that a Commission decision to go forward with any options program may have a substantial adverse effect on the Commission's ability to enforce the Commodity Exchange Act and the Commission's Regulations. This adverse effect might be mitigated by adoption of certain safeguards which, unfortunately, are not included in the present proposal and, to our knowledge, have not yet been given the close consideration they warrant.

PROBABLE EFFECTS ON SALE OF ILLEGAL OPTIONS

The Commission should realize that any lifting of the options ban will most likely increase the activity of persons selling illegal options and thus the burden on the Commission's enforcement program. The Division anticipates that the options pilot program will serve as both a guise and an advertising ploy for unscrupulous operators who are in fact selling illegal options. Particularly in those areas of the country where off-exchange instrument sales have been so troublesome, unscrupulous operators will misrepresent the nature of the Commission's program and seek to foist their unlawful instruments upon the unsuspecting public as "exchange-traded options". While any pilot program may result in an increase of such unlawful activity, the Commission may be able to mitigate the effects of such a program by restricting the program to a limited number of futures contracts and making clear in all public releases and statements the very limited scope and experimental nature of the pilot program.

MAJOR DEFICIENCIES IN THE CURRENT PROPOSAL FOR SALE OF LEGITIMATE OPTIONS

The options package as currently structured has two obvious deficiencies. The first is the lack of any real requirement for an automated transaction audit trail at each licensed exchange. Without a transaction reporting system which provides adequate market reconstruction capability, it will be virtually impossible for the exchanges to design trading surveillance systems to detect the forms of manipulative activities (especially reporting of non-existent transactions) which were encountered in the securities options markets. Moreover, any such violative conduct which may be detected will be very difficult to prove absent an audit trail. Second, there is no general requirement imposed upon member firms to ensure that only the right players participate in the game. Without some form of suitability rule and without account opening rules which require sufficient information about a potential customer to allow the firm to determine whether a particular customer can understand and bear the risk of transactions to be recommended, supervisors and compliance personnel within firms will have neither the incentive nor the ability to control the activity of salespeople. The SEC's Options Study found that the lack of these types of control procedures at the firm level was the primary cause of customer abuses which appeared in the securities options markets.

The absence of audit trail and suitability requirements undermines selfregulation of the options industry at both the exchange level and also the member firm level. Where, as here, self-regulatory controls are deficient, it is not unreasonable to expect that public customers and the integrity of the marketplace will suffer from the resulting abuses and, consequently, a large, and perhaps overwhelming, enforcement burden will fall upon this Commission.

CONCLUSION

In making any decisions concerning an options program, this Commission should be mindful of both the troublesome history of commodity options and also the difficulties encountered by the SEC in regulating its markets for securities options exchanges. We are not aware that the wealth of information and analysis generated by the SEC's Options Study has yet been fully assimilated by this Commission and its staff.

What is needed is a careful analysis of all this information and a free discussion among the staff and the Commission of the merits of alternative proposals. Only in this manner will the Commission be in a position to act responsibly and on the basis of all available information to design the most effective and efficient regulatory package for options trading. Of course, such a regulatory package is in the best interest of all the public, including the options industry and the public options customer. Finally, Congress and the public expect and deserve the Commission to propose and adopt the best regulatory program available and the Commission should act carefully to meet these expectations.

T. J. LOUGHRAN (X49501).

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